S. HRG. 99-94

AGRICULTURAL LENDERS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 795

PROBLEMS BEING EXPERIENCED BY THE AGRICULTURAL SECTOR OF THE COMMERCIAL BANKING INDUSTRY; AND S. 795, LEGISLATION WHICH EXTENDS THE NET WORTH CERTIFICATE PROGRAM TO AGRICULTURAL LENDERS

APRIL 26, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
47-312 O WASHINGTON : 1985

S241-13

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JAKE GARN, Utah, *Chairman*

JOHN HEINZ, Pennsylvania	WILLIAM PROXMIRE, Wisconsin
WILLIAM L. ARMSTRONG, Colorado	ALAN CRANSTON, California
ALFONSE M. D'AMATO, New York	DONALD W. RIEGLE, JR., Michigan
SLADE GORTON, Washington	PAUL S. SARBANES, Maryland
MACK MATTINGLY, Georgia	CHRISTOPHER J. DODD, Connecticut
CHIC HECHT, Nevada	ALAN J. DIXON, Illinois
PHIL GRAMM, Texas	JIM SASSER, Tennessee

M. DANNY WALL, *Staff Director*
KENNETH A. MCLEAN, *Minority Staff Director*
LINDA ZEMKE, *Counsel*

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS

SLADE GORTON, Washington, *Chairman*

JAKE GARN, Utah	PAUL S. SARBANES, Maryland
CHIC HECHT, Nevada	WILLIAM PROXMIRE, Wisconsin
PHIL GRAMM, Texas	ALAN CRANSTON, California
ALFONSE M. D'AMATO, New York	CHRISTOPHER J. DODD, Connecticut

JOHN WILLS, *Legislative Assistant*
VIRGINIA ANNE HOUSUM, *Counsel*
PETER KINZLER, *Legislative Assistant*

CONTENTS

FRIDAY, APRIL 26, 1985

	Page
Opening statements of:	
Senator Gorton	1
Senator Proxmire	2
Senator Dixon	3
Senator Sasser	175
Farm Credit Relief Act of 1985	177
Senate bill S. 795	10

WITNESSES

J. James Exon, U.S. Senator from the State of Nebraska	3
Participation in the Net Worth Assistance Program	4
Results of depressed agricultural economy	4
Prepared statement	6
Need for early involvement	13
Charles Grassley, U.S. Senator from the State of Iowa	15
Current credit crunch	15
Concern of bankers	16
Game of chicken being played	17
Prepared statement	19
Hawkeye Bancorporation, letter and information concerning agricultural banks by Paul D. Dunlop	24
Joint statement of the Federal regulatory agencies on their agricultural credit policy	31
J. Charles Partee, member, Board of Governors, Federal Reserve System	33
Origin of farm problems	33
Farm bank failures climb	34
Extension of Net Worth Assistance Program	36
Prepared statement	38
Diversification	47
Response to Senator Sasser's request to aid agricultural banks	50
Margaret L. Egginton, Deputy to the Chairman, Federal Deposit Insurance Corporation	53
No real crisis	53
Prepared statement	54
Response to written questions of Senator Gorton	68
Response to comments of Senator Sasser	69
Frank W. Naylor, Jr., Under Secretary of Agriculture for Small Community and Rural Development	59
Support for operating requirements	59
Prepared statement	61
Panel discussion:	
Over $2.5 billion committed to short-term needs	66
H.L. "Bud" Gerhart, chairman, agriculture committee, Independent Bankers Association of America; president, First National Bank, Newman Grove, NE	71
One-third of farmers experiencing difficulty	71
Prepared statement	73
Alan R. Tubbs, chairman, agriculture bankers division executive committee, American Bankers Association and president, First Central State Bank, De Witt, IA	79
Troubled banks	79
Farmers Home Administration	81

Page

Alan R. Tubbs, chairman, agriculture bankers division executive committee, American Bankers Association and president, First Central State Bank, De Witt, IA—Continued
Prepared statement 83
Problem banks 84
U.S. bank failures 84
Bank regulators 87
Net worth certificates 89
Farmers Home Administration 92
Farm Credit System 96
Farm Credit Council's proposed Agricultural Conservation Corporation 96
Secondary market for agricultural loans 97
Clear title for agricultural products 98
Alternative minimum tax 100
Bankruptcy 101
Food stamp handling charges 103
Conclusion 104
Attachment I: Estimated number of farms with cash shortfalls by sales class and debt/asset ratio, 1983 108
Attachment II: ABA agricultural bankers survey 109
Attachment III: Nonreal estate debt outstanding at reporting lending institutions—1976–84 116
Panel discussion:
Performance of small banks 117
Require new management 118
Walter Madsen, superintendent of banks for the State of Arizona, president and chairman of the Conference of State Bank Supervisors; on behalf of Roger Beverage, director, Nebraska Department of Banking and Finance, representing the Conference of State Bank Supervisors 120
Farm health undermined by four variables 120
State's role as primary regulator 121
Prepared statement of Roger Beverage 123
Nature of the problem 124
The role of bank regulation 126
Improving the quality of State regulation 129
Two possible solutions to the agriculture credit problem 133
Summary and conclusions 134
Chart: CSBS-supported education and training enrollments, 1972–85 135
CSBS press release 136
A. David Meadows, Associate Director, Division of Bank Supervision, Federal Deposit Insurance Corporation 137
Problems began in 1981 137
Prepared statement 139
Table 1: Sixteen Midwest and Plains States data 149
Table 2: Agricultural banks—performance characteristics 150
Table 3: Problem banks 151
Table 4: Agricultural bank failures 151
Response to written questions of Senator Gorton 68
John F. Downey, Chief National Bank Examiner, Office of the Comptroller of the Currency 152
Diversification blocked by State law 152
Opposed to short-term remedies 153
Prepared statement 155
Description of the farm problem 156
Agricultural banks mirror the condition of the local economy 160
The response of bank supervision 166
Other proposed remedies 169
Conclusion 172
Response to written questions of Senator Gorton 192
Response to Senator Sasser concerning legislation entitled "Farm Credit Relief Act of 1985" 197
Panel discussion:
Restructuring debt 174
Ongoing number of failures 185
Effects of interstate banking on farmers 186
Hindsight views 188

AGRICULTURAL LENDERS

FRIDAY, APRIL 26, 1985

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS,

Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Slade Gorton (chairman of the subcommittee) presiding.

Present: Senators Gorton, Proxmire, Cranston, Dodd, and Dixon.

Also present: Senators Exon and Grassley.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. The purpose of this hearing today is twofold. First, we need to continue our oversight over the problem of the agricultural economy and agricultural credit. Second, we want to hear the reactions of the banking regulators and others to proposals for Federal assistance in this area, especially Senator Exon's proposal to extend some kind of net worth assistance to agricultural banks.

Clearly, the special difficulties being experienced by our farmers and by many of those whose livelihoods depend on the farming sector demand Congress' compassionate attention.

Furthermore, congressional action may be appropriate not only to alleviate the pain of economic dislocation but also to facilitate adjustment to new economic realities.

From the narrow point of view of this committee's legislative jurisdiction, however, there may be an even more germane reason to examine this issue now.

The problems in the banking and related industries are not confined to agricultural banks. Real estate and energy are also sectors where bank asset quality has apparently declined and earnings remain weak, albeit for different reasons, in the mortgage lending industry.

Much of the banking industry is undercapitalized and an interest rate runup or a significant international loan default could create significant problems throughout the industry.

Let me make clear that I do not believe that any of our problems exceed our ability to manage them. There is no reason to doubt the fundamental safety and soundness of the U.S. banking system. Nonetheless, we are clearly also in a world in which inflation is no longer going to forgive questionable lending practices or failure to diversify loan portfolios, and I believe it behooves us to watch care-

fully the developments in the agricultural banking sector and how our regulators deal with these developments because they may have wider applicability than we would wish.

At this point I would like to ask Senator Proxmire if he has an opening statement.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman. I just have a very brief opening statement.

This is an extraordinarily challenging and difficult area. As I understand it, the Chairman of the Federal Reserve Board was before us and pointed out that most of the agricultural credit is made available by the Federal Government in various agencies. The best agricultural credit is probably in the hands of the commercial banks. We have had some failures and of course it's always spectacular and sad when we have those failures, but the number of failures really have been very modest in relationship to the number of institutions involved.

I think that we have to be aware also of the fact that this is, unfortunately, a very, very long-term problem.

In Wisconsin, for instance, in 1954, we had 107,000 dairy farms. Today, we have 40,000. Many of those farms that went out of business went out of business on the basis of having substantial loans with banks and undoubtedly some of the banks took a beating with losses in the course of that.

Unfortunately, this diminution in the number of farms has not stopped. It's continuing on a long-term basis. We have cycles when it's worse—some years it's worse than others, but I expect that maybe over the next few years the number of dairy farms in the State might go down to 20,000 or even 15,000 if the same trend continues, and I think it very well might.

By and large, these are extraordinarily efficient operations. The people who are left are the most efficient farmers; they work terribly long hours. The University of Wisconsin found that the typical Wisconsin dairy farmer worked 10 to 12 hours a day, 7 days a week, 52 weeks a year, made an investment of well over $200,000, and had a return that was less than the minimum wage, although the work is highly skilled.

It's kind of a heartbreaking situation and it's very difficult for the banks I know and for the Congress to cope with it.

The reason I am making this statement is because I think we have to recognize that this isn't something we can handle with just a 1- or 2-year panacea. It's something that we are going to have to recognize is going to persist year after year for some time to come. We are going to have to adjust to this very difficult problem.

I want to commend the chairman on calling these hearings. I think they can be very helpful to us. Also, it's great to see that sterling Senator from Nebraska sitting here and I hope about to testify to us. He's a dear friend of mine and a neighbor—lives across the street. Unfortunately, he decided he could no longer stand living across the street from me so he moved out of the neighborhood. We love him anyway.

STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, the problems faced by America's farmers are by now well known. These problems have received close scrutiny by the Senate, by experts throughout the country, and by our leading newspapers.

What is less well understood, Mr. Chairman, is that these problems threaten not just the farmers. They threaten the entire support system of farming: the banks, the merchants, and the equipment manufacturers; they threaten the communities and regions that are in turn supported by farming. The farmers' problems do not just ripple through the rural communities—they crash like waves, pounding the foundations of entire regions.

Agricultural banks are an important part of this foundation. We have distinguished witnesses before the subcommittee this morning. I look forward to hearing from representatives of the Federal and State banking regulators, from the Department of Agriculture, and from the banking industry. I want to thank you, Mr. Chairman, for your initiative in setting this hearing. I appreciate your willingness to examine the problems facing the agricultural sector of the banking industry.

Senator GORTON. With that testimony on the wisdom of the Senator from Nebraska, we will be happy to hear from him.

STATEMENT OF J. JAMES EXON, U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator EXON. I thank my colleagues very much and I'm delighted to be here this morning to testify before the committee on some tremendously important pieces of legislation and I will be introducing testimony today on behalf of the director of banking of the State of Nebraska. A very distinguished Nebraskan agricultural banker is here with us this morning and will be testifying on what the situation is and what we are going to do about it with regard to critical crisis situations that are confronting mainly the smaller agricultural bankers in rural America as a whole and Nebraska in particular.

Mr. Chairman, I am pleased that your subcommittee is holding this hearing on the problems facing many agricultural banks, and on my bill to extend the Net Worth Assistance Program to distressed agricultural lenders. I am also pleased that you will be hearing from a Nebraskan who has firsthand knowledge of the challenges facing agricultural banks. I am presenting a statement today from Roger Beverage, who is the director of the Nebraska Department of Banking, and that deals with these matters and the fact that the director of banking of Nebraska deals with these on an everyday basis and knows a great deal about the crisis situation and, more importantly, what we can do to alleviate that to some extent.

Bud Gerhart is here. Bud Gerhart will be testifying on behalf of the First National Bank of Newman Grove, NE, of which he is the principal owner, and on behalf of his position as chairman of the Agriculture-Rural America Committee of the Independent Bankers Association.

PARTICIPATION IN THE NET WORTH ASSISTANCE PROGRAM

I would like to take just a few moments to explain the provisions of my bill. Basically, it would make it possible for distressed agricultural lenders to participate in the Net Worth Assistance Program. That program was established, as the committee knows, in 1982 to provide capital assistance to distressed home lenders. In that event, if a home lender meets the requirements set out in the statute for being distressed, it can qualify for assistance from the FDIC or the FSLIC. The aid is in the form of a paper-for-paper exchange.

The lender issues a net worth certificate which is purchased by the FDIC with a promissory note. This promissory note is then part of the lender's capital and helps shore up their financial condition. The lender receives no cash so there is no direct cost to the Treasury. The only circumstance where Federal dollars are involved is in the event of the liquidation of the bank, when the normal insurance provisions of the FDIC are triggered. Basically, this program is an accounting tool whereby a troubled lender can keep its doors open, raise outside capital, and restructure its loan portfolio in order to improve its financial condition.

There are several tests that a lender must meet in order to qualify for assistance under my bill. First, it must have at least 20 percent of its loans in agriculture. Second, the lender must have incurred losses during the preceding two quarters which were not the result of fraud, speculation, or mismanagement. Third, the lender must have a net worth of less than 6 percent or a higher percentage if required to maintain such a higher percentage by a Federal or State regulator. My bill defines net worth as the ratio of capital to adjusted total assets. This 6-percent net worth test is different from the current law, which provides that a lender can qualify for the program if it has net worth equal to or less than 3 percent of its assets. My bill would insert the 6-percent test because commercial banks are required to have a minimum capitalization roughly double that that is required for the thrifts. Such a standard is necessary if the program is to be of any real benefit to distressed agricultural lenders. Finally, the lender must agree to comply with all the terms and conditions established by the FDIC.

I want to make it very clear that this program is in no way a bailout of banks that have been poorly managed. The law currently provides that the Net Worth Assistance Program is not available if the lender's difficulties are the result of fraud or mismanagement. My bill would not change that in any way. It would simply give the FDIC an additional tool for working with troubled agricultural lenders.

RESULTS OF DEPRESSED AGRICULTURAL ECONOMY

A significant number of agricultural lenders face serious problems because of high interest rates, the high value of the dollar, low-farm income, and the depressed market for farmland. Since July 1983, 10 banks have closed in my State and the depressed agricultural economy has been a major factor in most of those closings. As a result of these closings, hundreds of farmers must now deal with the FDIC on their outstanding loans, rather than their

local banker. Across the Nation, agricultural bankers face the difficult choice of foreclosing on farmers or risking their own liquidation or forced merger by bank regulators.

Mr. Chairman, a recent report prepared by the FDIC concluded that a large number of banks "appear to be highly susceptible to the ongoing agricultural stress." The report appeared in the January issue of FDIC's "Economic Outlook." It found that banks held $51.9 billion or almost one-third of the total outstanding farm debt and that 80 percent of that debt was not secured by real estate. Small rural banks in the 15 hardest hit States hold almost one-half—and I emphasize to my colleagues—one-half of all the farm loans held by banks. The report concluded that "the sheer volume of farm and farm-related debt held by U.S. banks is probably equal to, if not greater than, the volume of the Latin American debt."

I would simply add, we certainly all have a basic understanding here of the threat that the Latin American debt holds over our whole financial community.

Mr. Chairman, these are serious challenges facing agricultural lenders. I am concerned that the FDIC does not give these lenders the same consideration it gives to Continental Illinois and other institutions which are supposedly too large to fail. About 2 weeks ago, the State Bank of Alexandria was closed. Alexandria is a small community of 255 people in southeast Nebraska. While this closing will not affect the Nation's banking system, this was the only bank in that town and the closing will definitely affect the citizens and businesses in that community.

My bill would not create any new programs or impose any new duties on the FDIC. However, it would give some distressed agricultural lenders an opportunity to keep their doors open, to continue to serve their community and to work to get their financial condition in order. I look forward to hearing from the various witnesses about my proposal, as well as other alternatives for addressing the challenging situation facing our agricultural lenders.

Sometime later this morning—and I'm going to try and get back for his testimony if I can—will be Mr. Bud Gerhart, who I indicated earlier is a small town banker U.S.A. He not only is a leader in the agricultural banking circles of Nebraska, but he's one of the real leaders in understanding the whole difficulties facing agricultural banks, particularly small banks in rural America.

With that, I will be glad to try to respond to any questions that my colleagues might have, and I appreciate very much your consideration of the legislation I have introduced.

[The complete prepared statement and a copy of proposed bill, S. 795 follow:]

STATEMENT OF SENATOR J. JAMES EXON

BANKING SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

HEARING ON S.795, EXON NET WORTH ASSISTANCE BILL

APRIL 26, 1985

MR. CHAIRMAN, I AM PLEASED THAT YOUR SUBCOMMITTEE IS HOLDING THIS HEARING ON THE PROBLEMS FACING MANY AGRICULTURAL BANKS, AND ON MY BILL TO EXTEND THE NET WORTH ASSISTANCE PROGRAM TO DISTRESSED AGRICULTURAL LENDERS. I AM ALSO PLEASED THAT YOU WILL BE HEARING FROM TWO NEBRASKANS WHO HAVE FIRST HAND KNOWLEDGE OF THE CHALLENGES FACING AG BANKS. ROGER BEVERAGE IS THE DIRECTOR OF THE NEBRASKA DEPARTMENT OF BANKING AND DEALS WITH THESE MATTERS ON A DAILY BASIS. BUD GERHART IS THE PRESIDENT OF THE FIRST NATIONAL BANK OF NEWMAN GROVE, NEBRASKA AND IS SERVING AS CHAIRMAN OF THE AGRICULTURE-RURAL AMERICA COMMITTEE OF THE INDEPENDENT BANKERS ASSOCIATION.

I'D LIKE TO TAKE JUST A FEW MOMENTS TO EXPLAIN THE PROVISIONS OF MY BILL. BASICALLY, IT WOULD MAKE IT POSSIBLE FOR DISTRESSED AG LENDERS TO PARTICIPATE IN THE NET WORTH ASSISTANCE PROGRAM. THAT PROGRAM WAS ESTABLISHED IN 1982 TO PROVIDE CAPITAL ASSISTANCE TO DISTRESSED HOME LENDERS. IF A LENDER MEETS THE REQUIREMENTS SET OUT IN THE STATUTE FOR BEING DISTRESSED, IT CAN QUALIFY FOR ASSISTANCE FROM THE F.D.I.C. OR THE F.S.L.I.C. THE AID IS IN THE FORM OF A "PAPER FOR PAPER" EXCHANGE.

THE LENDER ISSUES A "NET WORTH CERTIFICATE" WHICH IS PURCHASED BY THE F.D.I.C. WITH A PROMISSORY NOTE. THIS PROMISSORY NOTE IS THEN PART OF THE LENDER'S CAPITAL AND HELPS SHORE UP THEIR FINANCIAL CONDITION. THE LENDER RECEIVES NO CASH SO THERE IS NO DIRECT COST TO THE TREASURY. THE ONLY CIRCUMSTANCE WHERE FEDERAL DOLLARS ARE INVOLVED IS IN THE EVENT OF THE LIQUIDATION OF THE BANK, WHEN THE NORMAL INSURANCE PROVISIONS OF THE F.D.I.C. ARE TRIGGERED. BASICALLY, THIS PROGRAM IS AN ACCOUNTING TOOL WHEREBY A TROUBLED LENDER CAN KEEP ITS DOORS OPEN, RAISE OUTSIDE CAPITAL AND RESTRUCTURE ITS LOAN PORTFOLIO IN ORDER TO IMPROVE ITS FINANCIAL CONDITION.

THERE ARE SEVERAL TESTS THAT A LENDER MUST MEET IN ORDER TO QUALIFY FOR ASSISTANCE UNDER MY BILL. FIRST, IT MUST HAVE AT LEAST 20% OF ITS LOANS IN AGRICULTURE. SECOND, THE LENDER MUST HAVE INCURRED LOSSES DURING THE PRECEDING TWO QUARTERS WHICH WERE NOT THE RESULT OF FRAUD, SPECULATION OR MISMANAGEMENT. THIRD, THE LENDER MUST HAVE A NET WORTH OF LESS THAN 6% OR A HIGHER PERCENTAGE IF REQUIRED TO MAINTAIN SUCH A HIGHER PERCENTAGE BY A FEDERAL OR STATE REGULATOR. MY BILL DEFINES "NET WORTH" AS THE RATIO OF CAPITAL TO ADJUSTED TOTAL ASSETS. THIS 6% NET WORTH TEST IS DIFFERENT FROM THE CURRENT LAW, WHICH PROVIDES THAT A LENDER CAN QUALIFY FOR THE PROGRAM IF IT HAS NET WORTH EQUAL TO OR LESS THAN 3% OF ITS ASSETS. MY BILL WOULD INSERT THE 6% TEST BECAUSE COMMERCIAL BANKS ARE REQUIRED TO HAVE A MINIMUM CAPITALIZATION ROUGHLY DOUBLE THAT REQUIRED FOR THRIFTS. SUCH A STANDARD IS NECESSARY IF THE PROGRAM IS TO BE OF ANY REAL BENEFIT

TO DISTRESSED AG LENDERS. FINALLY, THE LENDER MUST AGREE TO COMPLY WITH ALL THE TERMS AND CONDITIONS ESTABLISHED BY THE F.D.I.C.

I WANT TO MAKE IT VERY CLEAR THAT THIS PROGRAM IS IN NO WAY A "BAIL OUT" OF BANKS THAT HAVE BEEN POORLY MANAGED. THE LAW CURRENTLY PROVIDES THAT THE NET WORTH ASSISTANCE PROGRAM IS NOT AVAILABLE IF THE LENDER'S DIFFICULTIES ARE THE RESULT OF FRAUD OR MISMANAGEMENT. MY BILL WOULD NOT CHANGE THAT IN ANY WAY. IT WOULD SIMPLY GIVE THE F.D.I.C. AN ADDITIONAL TOOL FOR WORKING WITH TROUBLED AGRICULTURAL LENDERS.

A SIGNIFICANT NUMBER OF AGRICULTURAL LENDERS FACE SERIOUS PROBLEMS BECAUSE OF HIGH INTEREST RATES, THE HIGH VALUE OF THE DOLLAR, LOW FARM INCOME AND THE DEPRESSED MARKET FOR FARMLAND. SINCE JULY OF 1983, TEN BANKS HAVE BEEN CLOSED IN MY STATE AND THE DEPRESSED AGRICULTURAL ECONOMY HAS BEEN A MAJOR FACTOR IN MOST OF THOSE CLOSINGS. AS A RESULT OF THESE CLOSINGS, HUNDREDS OF FARMERS MUST NOW DEAL WITH THE F.D.I.C. ON THEIR OUTSTANDING LOANS, RATHER THAN THEIR LOCAL BANKER. ACROSS THE NATION, AGRICULTURAL BANKERS FACE THE DIFFICULT CHOICE OF FORECLOSING ON FARMERS OR RISKING THEIR OWN LIQUIDATION OR FORCED MERGER BY BANK REGULATORS.

MR. CHAIRMAN, A RECENT REPORT PREPARED BY THE F.D.I.C. CONCLUDED THAT A LARGE NUMBER OF BANKS "APPEAR TO BE HIGHLY SUSCEPTIBLE TO THE ONGOING AGRICULTURAL STRESS." THE REPORT APPEARED IN THE JANUARY ISSUE OF F.D.I.C.'S "ECONOMIC OUTLOOK."

IT FOUND THAT BANKS HELD $51.9 BILLION OR ALMOST 1/3 OF THE TOTAL OUTSTANDING FARM DEBT AND THAT 80% OF THAT DEBT WAS NOT SECURED BY REAL ESTATE. SMALL RURAL BANKS IN THE FIFTEEN HARDEST-HIT STATES HOLD ALMOST ONE-HALF OF ALL THE FARM LOANS HELD BY BANKS. THE REPORT CONCLUDED THAT "THE SHEER VOLUME OF FARM AND FARM-RELATED DEBT HELD BY U.S. BANKS IS PROBABLY EQUAL TO, IF NOT GREATER THAN THE VOLUME OF LATIN AMERICAN DEBT."

MR. CHAIRMAN, THESE ARE SERIOUS CHALLENGES FACING AG LENDERS. I AM CONCERNED THAT THE F.D.I.C. DOES NOT GIVE THESE LENDERS THE SAME CONSIDERATION IT GIVES TO CONTINENTAL ILLINOIS AND OTHER INSTITUTIONS WHICH ARE "TOO LARGE TO FAIL." ABOUT TWO WEEKS AGO THE STATE BANK OF ALEXANDRIA WAS CLOSED. ALEXANDRIA IS A SMALL COMMUNITY OF 255 IN SOUTHEAST NEBRASKA. WHILE THIS CLOSING WILL NOT AFFECT THE NATION'S BANKING SYSTEM, THIS WAS THE ONLY BANK IN THAT TOWN AND THE CLOSING WILL DEFINITELY AFFECT THE CITIZENS AND BUSINESSES IN THE COMMUNITY.

MY BILL WOULD NOT CREATE ANY NEW PROGRAMS OR IMPOSE ANY NEW DUTIES ON THE F.D.I.C. HOWEVER, IT WOULD GIVE SOME DISTRESSED AGRICULTURAL LENDERS AN OPPORTUNITY TO KEEP THEIR DOORS OPEN, TO CONTINUE TO SERVE THEIR COMMUNITY AND TO WORK TO GET THEIR FINANCIAL CONDITION IN ORDER. I LOOK FORWARD TO HEARING FROM THE VARIOUS WITNESSES ABOUT MY PROPOSAL, AS WELL AS OTHER ALTERNATIVES FOR ADDRESSING THE CHALLENGES FACING AG LENDERS.

II

99TH CONGRESS
1ST SESSION

S. 795

To amend section 13(i) of the Federal Deposit Insurance Act.

IN THE SENATE OF THE UNITED STATES

MARCH 28 (legislative day, FEBRUARY 18), 1985

Mr. EXON introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend section 13(i) of the Federal Deposit Insurance Act.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 13(i) of the Federal Deposit Insurance Act (12 U.S.C. 1823(i)) is amended by adding at the end thereof the following new paragraph:

"(14)(A) The Corporation is authorized to use the authority contained in this subsection to purchase net worth certificates of any qualified institution which—

"(i) has investments in agricultural loans aggregating at least 20 per centum of its loans; and

"(ii) otherwise satisfies the requirements of this paragraph.

"(B) In any case in which a qualified institution described in subparagraph (A) is required to maintain a net worth greater than 6 per centum by any State or Federal banking agency, the Corporation shall be required to consider purchasing net worth certificates as an alternative to a merger, purchase and assumption, liquidation, or any other similar action.

"(C) For purposes of this paragraph, the term 'qualified institution' means a qualified institution within the meaning of paragraph (2), except that for the purpose of this paragraph, an institution—

"(i) satisfies the requirements of paragraph (2)(A) if such qualified institution has a net worth less than—

"(I) 6 per centum; or

"(II) such higher percentage as it may be required to maintain by any State or Federal banking agency;

"(ii) is not required to satisfy the requirements of paragraph (2)(F);

"(iii) satisfies the net worth requirements of paragraph (5)(A) if such qualified institution has a net worth greater than 6 per centum;

"(iv) satisfies the net worth requirements of paragraph (5)(B) if such qualified institution has a net

worth greater than 4 per centum and less than or equal to 6 per centum; and

"(v) satisfies the net worth requirements of paragraph (5)(C) if such qualified institution has a net worth greater than zero and less than or equal to 4 per centum.

"(D) For the purpose of this paragraph, the term 'net worth' means the ratio of capital to adjusted total assets.

"(E) For purposes of this paragraph, the term 'agricultural loan' includes all secured and unsecured loans, credit sales, forbearances, advances, renewals, or other extensions of credit made to any person or organization engaged in the production of agricultural products or made to farm cooperatives and for an agricultural purpose, as defined by the Corporation.".

○

Senator GORTON. Senator, I thank you very much for your testimony and I find your proposal intriguing and, of course, we will hear a great deal of discussion of it later on this morning from other witnesses.

You are more than welcome to come up here and join your fellow Senators on the panel and to question the other witnesses. We are delighted to have you here in this room.

Since you began to speak, my colleague from Illinois, Senator Dixon, has joined us. He has an opening statement which will be included in the record immediately after that of Senator Proxmire. I will now defer to Senator Proxmire.

Senator PROXMIRE. I just have one question, Senator Exon.

The FDIC contends that a Net Worth Certificate Program for agricultural banks will only postpone, not prevent, failure. The FDIC apparently believes that time is not on the side of the troubled agricultural bank.

What's your response to that view? And if we provide net worth assistance, what factors do you see on the horizon to allow these troubled banks to get back on a sound footing?

Senator EXON. Senator Proxmire, I think that's a good question and in some cases I would say—and I suspect that if that same question is asked of others who will be testifying this morning that the answer to the question raised by the FDIC is probably so in many instances—probably so in many instances.

NEED FOR EARLY INVOLVEMENT

What we find out, though, in the bureaucracy, at every level of government, sometimes they can't see the forest for the trees. FDIC should, in my opinion, have moved in a lot quicker than they did on Continental Illinois and other institutions in Oklahoma. The FDIC seems to have the basic idea that they should stay one step removed until the failure of an institution.

I suspect that the FDIC, although I'm not certain, opposed the FSLIC arrangement that the Congress in its wisdom--and I think correct wisdom—encouraged the FSLIC a couple years ago, "Look, get involved, regulators." If you are facing a loss sometime in the future, maybe by early and constructive action of a helpful nature, as my bill has suggested, maybe—and I think it is true—that a substantial number of those institutions that would certainly otherwise fail if FDIC sits on their hands—to substitute a word that first came to my mind but I decided to correct it—to sit on their hands and do nothing until the institution is beyond repair, and then they move in, as they are required to do and as they should do.

To answer your question and that of the FDIC is simply that's a judgment call, Senator Proxmire, and I believe and I hope that it is the judgment of the Congress that we should get the FDIC involved in saving some of these institutions early on rather than waiting for the ax to fall.

I would simply say as a final response, let's assume for a moment that every bank that would qualify for assistance under the Exon bill would eventually fail. I would simply say that in that event the FDIC would lose no more or no less of their funds than they would

by going ahead and enthusiastically support and work out the Exon bill.

So this is a remedy factor and I would say that the same reasoning and rationale that encouraged the Congress to overcome the bureaucracy a couple years ago with regard to the thrifts—the same basic reasoning should be applied in passing this measure which I think could not help but be of constructive help.

Obviously, though, it's not a panacea. It's not going to solve all the problems.

Senator PROXMIRE. Thank you very much.

Thank you, Mr. Chairman.

Senator GORTON. Senator Dixon.

Senator DIXON. Well, I want to congratulate my colleague on his very excellent presentation and on the concept of this bill and I would just ask him this question.

It's clear, is it not, Senator, that this is a discretionary thing on the part of the FDIC? First of all, the bank must meet all the criteria you set forth in the bill and in your statement, and then in the final analysis a decision whether to go ahead by the issuance of the certificate and so forth is discretionary, is it not, in the FDIC?

Senator EXON. The answer to the question from the Senator from Illinois is correct and that's the basic secret and beauty of the plan. It gives the FDIC an additional tool to help if it wants to.

Senator DIXON. Well, I want to say that I like the idea and, while my dear friend and seatmate and distinguished colleague has to some extent maligned the assistance granted to Continental here, may I say that as a man who supported with enthusiasm what was done with the Continental, everybody in this room ought to know that the Continental has had two excellent quarters, that it will in the end support the statement by this Senator in this committee that it will make money for the Government of the United States, not lose money, because Continental is back on its feet and under the excellent leadership of John Swearingen and Bill Ogden and it's had two excellent quarters and will go on to be once again once of the great leading financial institutions in the world.

I am delighted to entertain suggestions from Nebraska banks just as my colleague from Nebraska was willing to acquiesce when we did what needed to be done for the Continental.

Senator EXON. I would say and explain to my colleague from Illinois that I had temporarily forgotten that Continental Illinois was an Illinois bank. [Laughter.]

Senator DIXON. Well, I had forgotten your Nebraska football, too, Senator.

Senator EXON. I would only say—and I think you make a good point. I would only say that we in Nebraska have wished, Senator Dixon, that for whatever the reasons the FDIC had been as forthcoming with the 10 banks that failed in Nebraska as they were with Continental Illinois, and I think that if there is a shame—if there is a shame with regard to the way we regulate, we help out the big because we have to and we don't care so much about the little. I think the law should be fairly and equitably enforced. My bill is a step in that direction.

I thank the chairman, I thank my friend from Illinois, and I thank my neighbor across the street who couldn't stand it any

longer and had to leave to go back and see whether his property had gone up in value since it was announced that Exon was leaving his community. [Laughter.]

Any further questions?

Senator GORTON. No. Thanks very much.

Senator Grassley has arrived. Are you ready with your statement now, Senator?

Senator GRASSLEY. Yes.

Senator GORTON. We are delighted to have you here as well.

STATEMENT OF CHARLES GRASSLEY, U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Thank you, Mr. Chairman. I want to say to the entire committee—Senator Dixon, who is the other member present—that we greatly appreciate your holding the hearings that you're having today to discuss the seriousness of the debt crisis facing the agricultural community. There is no question that a serious problem exists. I think everybody acknowledges that.

The present crisis is not simply the result of greedy farm speculators and unwise banking decisions during the 1970's, although I would have to say that is a part of it. However, there are a lot of political decisions made in Washington and acts of nature beyond the control of the individual farmer which we must also consider as part of that crisis. We not only can address that here in the Congress of the United States—we have a responsibility to address it now. There has been an historical tradition by the Congress of the United States to address those things that have been beyond the control of the individual farmer.

CURRENT CREDIT CRUNCH

The current agricultural credit crunch is not only affecting farmers. It's also affecting small main street businesses and even the lenders themselves are hurt as a result of this. It's all due to our economy—1 out of 5 jobs in the United States as a whole, and in my State, 7 out of 10 jobs are directly related to agriculture. About 10 percent of the farmers in Iowa are faced with the current credit crunch. An additional 20 to 30 percent could face the same situation within the next 2 years. I think that we have to work together and I know this committee is holding these hearings for that reason—working together as farmers, bankers, regulators, and the Federal Government to seek and find a solution to these problems facing so many people.

Earlier this year, I held a hearing as chairman of the Subcommittee on Administrative Practices and Procedures of the Judiciary Committee to examine whether or not the practices and policies of the banking regulators were hindering the recovery of the agricultural economy from the present recession.

Since that hearing on March 25, several more bankers have come to me and said that additional undue pressure—and I want to emphasize undue pressure—has been applied by the Federal regulators during recent bank examinations. This appears to be related to a dramatic change of departure in examination procedure by the bank regulators that I think is a part of the current problem. It

may be just a small part of the problem, and changing examination procedure may not be a solution to the problem, but it is a concern which we ought to address. This is one of many possible ways of finding a solution to this problem.

One of the main contentions of bankers in my State that I have spoken with or bankers who have written my office has to do with the classification of substandard loans. Too often the regulators are coming in and classifying as substandard the entire credit lines when in fact only a part of such a line is substandard.

One example presented to me—and if the committee wants more examples just let me know—concerns a real estate loan on a home which had been on the bank's books for over 6 years and never been delinquent. Another loan held by that same person was classified as substandard and the regulators classified the home loan substandard as well.

By classifying excessive numbers of loans the potential for losses is exaggerated. The current classification standards used in agricultural bank examinations are further destabilizing the condition of Iowa's economy unnecessarily.

Claims have been made that the examination policies and procedures of the various regulatory agencies are often in conflict. One regulator will classify a loan and another one will not, or will classify it differently.

Regulators are applying a double standard which appears to give preferential treatment to large banks while severely tightening up their classification procedures for smaller rural banks for farm loans. To some extent, there is a feeling that there is a different treatment of agricultural loans versus foreign loans in general.

CONCERN OF BANKERS

Bankers have said that they fear and this is a sad situation, bankers have told me that they fear retribution for expressing concerns about examinations in their banks to their elected officials. Regulators have offered sharply conflicting and inconsistent examining reports. Bankers are being told one thing at the conclusion of an examination, while the written report to the regulatory agencies differs.

The farm debt crisis is further exacerbated by the regulators requiring, either explicitly or implicitly, that the farmland used as collateral for many loans be devalued on the bank books far below what is considered reasonable, even considering the fact that we are in extraordinary times. Everybody will admit that there has been a dramatic drop in the value of land, not only in Iowa but including most agricultural land all over the country. This devaluation appears more arbitrary on the part of the examiners than it ought to be. No individual consideration is being given. The publicity of this is further contributing to the devaluation of the land than the market would dictate at the present time.

On March 25, 1985, I held a hearing in which I presented testimony on the problems faced by the bankers. I had a followup hearing 3 weeks ago in Sioux City to further explore the nature of the farm debt crisis and to learn the reasons why the President's Debt Adjustment Program is not working. The relevance of the Debt Ad-

justment Program to the overall health of our world banking system is important inasmuch as it gives the agricultural lenders the opportunity to stabilize classified farm loans by offering lenders a Farmers Home Administration loan guarantee in exchange for writing off sufficient principal and/or interest to bring the borrower to a cash-flow position. Although lenders have been utilizing a number of other Farmers Home Administration guaranteed programs, activity in the Debt Adjustment Program has been light.

One of the reasons is because Farmers Home Administration has decided not to utilize the existing real estate farm ownership guarantee authority to cover land debt. I see that Mr. Naylor is on your program for this morning, and hopefully he will address this issue, although I know he disagrees with us. Several of us have addressed this point to the President, particularly relative to the fact that the farm ownership authority is in the regulations. This authority ought to be utilized. It was in the Senate resolution that passed in February, and it was our intent that it be utilized. Implicit in that resolution are a lot of private discussions between Members of the Senate and the administration on what we meant by that resolution. I think it's clear that the administration meant to use the farm ownership guarantee authority. The administration needs to put its money where its mouth is. They intended to use that program and it's not being used.

GAME OF CHICKEN BEING PLAYED

There's a game of chicken being played between the USDA and the Farm Credit System. The USDA says that if they move in too quickly they will be bailing out the Farm Credit System. They want the Farm Credit System to use all of the resources available to them—and I agree with that point. But while we're playing a game of chicken, I don't think we can hold the banks of this country and the farmers of this country hostage while we're trying to create some sort of credibility for the USDA and the Farm Credit System.

The Farm Credit System would exist without the help of the Federal Government. There are a lot of people out there, both bankers, farmers, and small business people. Seven out of 10 jobs in my State are being hurt while we're having turf problems here at the Federal level. It seems to me that we have not only the ability but the responsibility to get these problems within the Government resolved.

Those are the problems [illegible] are dealing with. I believe we can deal with these problems, and we must deal with them. You have bankers here today that are going to speak to that issue. You have administration people that are going to speak. The bottom line is that we need to move.

I notice that you have not only a friend but an outstanding banker from the State of Iowa, a friend of mine, Alan R. Tubbs, on panel 2. This gentleman has worked tirelessly, and has made probably a dozen trips since Christmas to Washington to help clarify the problems in rural banking. Five hundred banks out of the 650 in my State are rural banks as defined by 25 percent of their loans being agricultural-oriented loans. There is a lot of understanding of

the problem out there. There are a lot of rural banking problems that need to be made clear here in Washington. The only reason I bring up Continental Illinois—and I do know that it's in Illinois and I do know that it's Senator Dixon's bank, is that there appears to have been a double standard in this country and the attention given in Washington to bailing out Mexico, Argentina, Brazil, the International Monetary Fund, and Continental Illinois greatly exceeds that given to rural agricultural banks. If we would put one-tenth of the resources and time utilized in resolving those problems into resolving the problems of rural banks a solution would be reached.

This problem is four or five times greater. We have 215 billion dollars' worth of agricultural debt in this country. That's equivalent to four Continental Illinois. All of the problems of Mexico, Brazil, and Argentina, I believe, added up to about $59 billion, and that's another four times—you have to have four of those to add up to the problems faced by the rural farm credit system.

This problem is serious. Even more serious, however, is the ripple effect this country will experience. We worried about that ripple effect relative to the Mexico and Argentinian debt crisis, and again with Continental Illinois. We must give the same amount of attention to the ripple effect of the farm debt problem and the banking crisis faced by agricultural bankers. Five in Iowa have gone under already this year, three last year. There have been at least eight in the State of Nebraska. I appreciate the Banking Committees efforts to resolve this problem, and commend you again for holding this hearing.

[The complete prepared statement and additional material supplied for the record by Senator Grassley follow:]

STATEMENT OF

SENATOR CHARLES E. GRASSLEY

BEFORE THE SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS

April 26, 1985

Mr. Chairman, Members of the Subcommittee, I appreciate the opportunity to discuss the seriousness of the debt crisis facing the agricultural community of our nation. I am pleased that the Senate Banking Committee is addressing, among other things, the regulatory practices which may be exacerbating this serious situation and exploring the possibility of issuing net worth certificates to troubled agricultural banking institutions.

There is no question that a serious problem exists in our agriculture-based states. The present farm credit crisis is not simply the result of greedy farm speculators and unwise banking decisions during the 1970s. The economic realities of agriculture in the 70s were reversed by low inflation and the strong dollar. This current credit crunch is putting the final hole into many farmers' hopes of ever farming again.

The current agriculture credit crunch is not only affecting farmers, but also many small mainstreet businesses, and lenders who depend upon a healthy agriculture economy for their business. I speak of the local grocer, the corner drug store, and many other agriculturally-related businesses such as farm implement dealers and seed dealers. In short, four out of five jobs in Iowa are dependent upon agriculture.

About 10 percent of Iowa's farmers are faced with the current credit crunch. An additional 20 to 30 percent could be in this same situation shortly if action is not taken. We must all work together, the farmers, the bankers, the regulators, and the federal government, to seek and find a solution to these problems facing so many people.

Earlier this year, I held a hearing as Chairman of the Subcommittee on Administrative Practice and Procedure to examine if the practices and policies of banking regulators were hindering the recovery of our agriculture economy from the present recession. Since that hearing on March 25th, several more bankers have come to me and said that additional undue pressure was being exerted by the regulators during bank examinations. This includes the FDIC, the OCC and the Fed.

One of the main contentions of Iowa bankers has to do with the classification of substandard loans. Too often, regulators are classifying as substandard entire lines of credit when, in fact, only a single part of such a line is substandard. For example,one borrower had a real estate loan which had been on the banks books for over six years, and had never been past due. Another loan held by that same person was classified as substandard, and the regulators made the home loan substandard as well. By classifying excessive numbers of loans, the potential for losses is exaggerated. The current classification standards used in ag bank examinations are further destabilizing the condition of Iowa's economy.

Claims have been made that the examinations policies and procedures of the various regulatory agencies are often in conflict; where one regulator will classify a loan, another one will not, or will classify it differently. Regulators are applying a double standard which appears to give preferential treatment to large banks with foreign loan problems, while severely tightening up their classification procedures on small rural banks with farm loans. Bankers have said they fear retribution for expressing concerns about examinations and their examiners. Regulators have offered sharply conflicting or inconsistent examination reports:

bankers are being told one thing at the conclusion of an examination, while the written report to the regulatory agency differs. The farm debt crisis is further exacerbated by the regulators requiring explicitly or implicitly that the farm land used as collateral for many loans be devalued on the banks books. I would at this point like to insert testimony presented before my March 25, 1985 hearing which expands upon the problems faced by bankers.

I held a follow-up field hearing in Sioux City to explore further the nature of the farm debt crisis, and to learn the reasons why the President's Debt Adjustment Program (DAP) was not working. The relevance of the DAP program to the overall health of our rural banking system is important in as much as it gives the agriculture lenders the opportunity to stabilize classified farm loans by offering lenders a Farmers Home Administration loan guarantee in exchange for writing off sufficient principle and/or interest to bring the borrower to a cash flow position.

Although lenders have been utilizing a number of other FmHA guarantee programs, activity in the DAP program has been light. One of the reasons is because FmHA has decided not to utilize existing real estate Farm Ownership guarantee authority to cover land debt. This has greatly hindered the use of DAP, particularly for member banks for the Federal Land Bank, but also to some degree by commercial lenders.

I have joined a number of Senators in a letter to the President requesting his review of this decision, but as yet have not received a decision. I urge the members of the Senate Banking Committee to join us in urging the reversal of this decision not to utilize Farm Ownership authority for the DAP program because it can have a positive effect on overall, long-term health of our Midwest lending institutions.

Recently, Robert Brenton, president of Brenton Banks, Inc., of Des Moines, Iowa, said that if the present situation is not stabilized 75 -150 banks will fail in the next 12-18 months in Iowa, Minnesota, Missouri, Nebraska, Kansas, and South Dakota. Just yesterday, I learned that the Federal Deposit Insurance Corporation opened a branch office in Des Moines, and has 60 liquidators ready to go to work. I have not been able to verify this figure, or determine the purpose of this branch office, but it seems obvious that the FDIC is planning to close a large number of financial institutions across my State. It is my hope that Mr. Meadows from the FDIC will provide this Subcommittee with additional information relative to the opening of this branch office.

I commend the Senate Banking Committee for taking action on this subject, and thank the Subcommittee on Financial Institutions and Consumer Affairs for holding this hearing today.

Exhibit #2 to the Subcommittee on Financial Institutions, Committee Banking, April 26, 1985

Hawkeye Bancorporation

March 11, 1985

The Honorable Charles E. Grassley
United States Senate
135 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Grassley:

I was asked to appear before your Senate Judiciary Subcommittee on Administrative Practice and Procedure.

On February 28, 1985, the seven Iowa multi-bank holding companies met in your office at a meeting with representatives of Federal Deposit Insurance Corporation, Comptroller of the Currency and Federal Reserve Board of Governors. This meeting was arranged by you at our request so we could discuss the recent harshness of regulatory examinations.

Attached to this letter are the following exhibits:

1. A summary of the areas discussed referred to above.

2. Excerpts from a recent article in American Banker, "When Regulators are Unfair."

3. Definition by regulators of how they will judge an asset "substandard."

4. Joint statement of federal regulatory agencies on their policy to view agricultural credit.

5. Seven letters by Iowa banks citing 50 different loan situations where in recent examinations they feel federal examiners did not follow their policies expressed in "4" and "5" above.

The seven letters have 50 different loans discussed totaling $7.5 million in classifications of which approximately $2 million meet the definition of "substandard" as published by federal regulatory authorities. These 50 misclassified loans required the banks to add almost $1 million in allowance for loan losses. These 50 misclassified loans have caused at a minimum ten forced farm liquidations which need not have occurred.

The letters speak for themselves as to the changing attitudes of federal regulators as to agricultural credit and the harm they are causing the State of Iowa.

Yours very truly,

PAUL D. DUNLAP
President

The Comptroller of the Currency and the Federal Deposit Insurance Corporation have over the past few months caused a decided change in the manner in which agriculture credits are reviewed in bank examinations.

The change started with the Penn Square Bank fiasco and became very evident immediately following Continental-Illinois National Bank's near collapse. Both agencies' Washington spokesmen deny they have caused this to occur. There are many instances where field examiners acknowledge openly it has occurred.

The changed attitudes are as follows:

1. "Cash flow" alone seems to be the criteria for loan classification. If the farmer can't demonstrate a positive cash flow over one year's operation the line is classified regardless of the amount of collateral.

2. The Comptroller, more than the FDIC, if a loan appears substandard, they will classify the total amount borrowed regardless of the fact a portion of the line is adequately secured and performing properly. Example: three loans to a farmer, one on real estate, one on machinery and one on planting the crop. Loan to current value on land and machinery 50% and all payments have been made as agreed. Examiner determines the "operational loan may not 'cash flow'" not only is the "operational loan" classified but the other two as well where there is no likelihood of loss.

3. Because of the large amounts of credit being classified, much of it not in danger of loss, a bank's classified loans increase dramatically. The larger classification at 60% of bank's capital accounts or more automatically triggers an "Administrative Action" or a Memorandum of Understanding or the severe Cease and Desist.

   A recent study appearing in American Banker pointed out that 97% of all Administrative Actions have been directed against banks under $100 million in asset size and none against money center banks.

   On the increased classifications the Comptroller requires the bank as a minimum to charge off all loss classifications, 50% of doubtful and 10% of substandard and to maintain 7% capital.

4. The timeframe to work with troubled credits has been shortened to not longer than the quarter in which the classification occurs. Prior to Continental-Illinois and Penn Square, a bank could work with Comptroller and FDIC and determine the approximate amount of reserves needed to cover classifications and then accrue from earnings that amount necessary over the remaining year.

   It is not uncommon now for the regulator to give you so many hours to have new capital contributed and threaten you that if you don't they will declare the bank to have impaired capital and any loans made thereafter will be illegal and you and your directors will be personally liable.

This is done orally and before you are given a written copy of their examination report.

5. The federal regulators' harshness in revaluing collateral in many instances is unreasonable. Farm machinery valued at current prices on a dealer's lot or as advertised in want ads is slashed as much as 50% justified by the examiner that if an auction was to be held it wouldn't bring as much.

   In Iowa, in some counties there is no market for farm real estate. To constantly slash farm real estate values to where there is no market is to just intensify the problem. Where bankers are willing to take foreclosed real estate off the public market regulators should be willing to allow writedowns over a "trailing average" while the land is withheld.

6. Financial accounting standards #15 has been justification to force a discounted value on loans restructured. Example: $25,000 loan where house was collateral to the loan. Foreclosed and sold for $23,000. Interest on prior loan 13%, new interest 8¼% - regulatory authorities invoking FASB #15 made bank carry loan at value of $16,000 because of discounted interest reduction over ten years.

   FDIC has said they have reconsidered and now they are about to release a memorandum not requiring a revaluation if the interest reduction is to the same individual. This accommodates the Farm Home Administration interest writedowns et al.

   There are still many assets in liquidation which could be sold if better terms are provided such as lowered interest rates. This is especially true on farm foreclosed real estate. Why can FDIC accommodate FHA interest writedowns and declare FASB #15 doesn't apply but on liquidated assets to a third party FASB #15 still applies?

7. Many times what is orally discussed at an examination is not what appears in the written examination. The supervisory authority of the field examiner is in many instances causing the written report to be much harsher than what the field examiner said would appear.

8. The field examiners have in many instances stated the new harshness of examination procedures are so if conditions continue to deteriorate and if the particular bank does in fact get in trouble no one will be able to blame them that they weren't doing their job. The sins of Penn Square and Continental-Illinois are being paid for by penalties imposed on the small agricultural banks of America.

9. FDIC and Comptroller Washington spokesmen deny that foreign loans made by money center banks have been treated differently than agricultural loans of small rural banks. The fact that interest has been loaned not only by the money center banks but by the Federal Reserve itself to keep foreign loans from defaulting, the fact that a significant number of the borrowers cannot now make principal payments or only token payments, the fact that repayment of foreign loans may take decades, the fact banks trade foreign loans between themselves at discounts but carry those loans at full value, are all indisputable evidence of such a difference does exist. Mr. Volcker himself has said "time is needed for these countries to work out of their problems." In rural America the federal regulators

refuse to give agriculture any time to work out of their problems but rather have called their loans due and payable immediately.

10. Misrepresentation in Washington cannot be excused on basis "the public shouldn't know." Mr. Charles Thacker, FDIC, December 13, 1984, in Des Moines, Iowa, and in an article appearing in the Des Moines Register on February 26, 1985, has stated agriculture problems in the Midwest are not a serious problem for Midwest agriculture banks. Banks have only 30% of agriculture credit and most of the "bad agriculture credit is in Farm Home Administration. Even if all 4,161 agriculture banks were to fail it wouldn't be as big a "drain" as if Citicorp were to fail."

    In Iowa, eliminating farm real estate loans held by Federal Land Bank, over 60% of all agriculture credit is held by banks. The Farm Home Administration has 14%. Thomas Huston, Superintendent of Banking, has publicly stated 132 Iowa banks have serious agricultural loan problems and this represents 24.5% of all state banks. Over half of all Iowa banks have not had an examination in the last seven months and if such was done the number would be well above 132 banks.

    When confronted with this, Mr. Thacker's reaction was "it's better to misrepresent to the public the facts than risk their loss of confidence in the banking system." Lack of truth in Washington undermines public confidence far more than the facts themselves. A rather odd paradox is the FDIC's present advocacy that what is needed is more disclosure of a bank's problems such as publicity of "administrative actions" as then the market discipline will be more keenly felt by the errant bank.

What is the consequence of the current attitudes of the federal regulatory authorities?

1. Rather than helping the situation they are causing it to be more severe.

2. Their pressure by harsh classifications backed by administrative actions with required capital injections forces the liquidation of many farmers who would not need to be liquidated had the bank regulators not turned the vice.

    A farmer with 50% equity in his land who can pay the interest and some principal is better off to be left in operation, than liquidated because he couldn't completely cash flow in that particular year.

3. The dollar size of classifications many of which a portion of the credit is in no danger of loss has caused unreasonable capital contribution to reserves. A large number of owners of banks are being forced to a "capital poor" position. The bank may be strong but it's owner weak. In Iowa 640 banks, the great majority are owned individually or in groups and have no public stock market to turn to for additional capital injection. The quickest way to consolidate Iowa's banking industry into a few large out-of-state owners is to continue requiring unreasonable capital contributions.

4. Shortening the timeframe. If time forebearance will help foreign borrowers why won't time forebearance help domestic borrowers?

5. Harsh downward valuation to "auction values" only pushes values that much lower.

6. The regulators' attitude that these actions are necessary so as they won't be open to criticism is not justification to ruin an industry, especially an industry which is 90% of Iowa's economic life.

7. FASB #15 makes it very difficult to give competitive interest rates to buyers of liquidated farm real estate. Foreclosed farm real estate shouldn't be forced to have higher interest rates than what is traditionally charged on farm real estate contracts. If FASB #15 can be waived on interest writedowns to same owners, why not to new owners?

8. Administrative actions should not be imposed automatically based only on the size of the classifications. Administrative actions should only be used when the bank refuses to cause to happen what regulatory authorities want to happen. After a bank receives a highly critical examination a bank should have a reasonable time to correct the deficiencies before an administrative action is automatically issued. The Comptroller of the Currency is becoming notorious for automatic administrative actions.

9. Lack of truth in Washington can never be justly rationalized.

What can be done by federal regulators to help?

1. Not make "cash flow" the only criteria for classification. Capacity, collateral and character are still valued guides.

2. Only classify those loans which may cause loss rather than total lines. Classifications should reflect potential loss.

3. Require reasonable loan loss allowances and reasonable time in which to provide. Don't cause automatic administrative actions based on classification alone.

4. Reasonable valuations of machinery based on sale prices on dealer lots and want ads.

5. Eliminate FASB #15 and discounted earnings charge on repossessed property sold to a third person, especially farm real estate.

6. Time to work out problems. Treat the American farmer the same as the foreign borrower.

7. Integrity in regulation. What is told at examination review is reflected in written examination. What is said by the field examiner, the regional personnel, is said in Washington. Concerns for the borrower, the bank, the industry, rather than protecting one's self.

C. Westbrook Murphy, a partner in the law firm of Baker and Hostetler of Washington, D.C., in the December 14, 1984 issue of the American Banker in an article, "How to Change from Lamb to Lion When Regulators are Unfair,' stated in part:

> ". . . Other examiners are classifying as "substandard" or worse loans that are fully protected by collateral, or are being paid currently, or both. These classifications contradict even the regulator's own definitions of a classified loan.
>
> These arbitrary classifications then are aggregated, until the bank's loan loss reserve, its income, and perhaps even its capital are seriously impaired.
>
> For good measure, the examiner also throws in some inadvertent and technical violations of law, plus at least one transaction that is written up to appear as insider self-dealing. Bank management is painted at best as lax or incompetent, and at worst as unethical or dishonest.
>
> . . . He (the banker) receives threats of enforcement actions, money penalties, and director liability if the bank fails to "correct" whatever deficiencies the examiner perceived.
>
> Confronted by these threats, most bankers knuckle under. At least nine out of every ten cease and desist orders are entered by agreement . . . and become as unassailable and as binding as if it had been inscribed in stone on Mount Sinai.
>
> . . . The cease and desist power is confined by the court to 'a means of correcting improprieties, and not as a punitive form of relief.'
>
> . . . Bankers need to demonstrate to their political leaders the impact of arbitrary enforcement not only on the banks, but also on the credit needs of the banks' communities. . ."

As defined in the FDIC Manual of Examination Policies, a substandard asset is:

(a) "inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any";

(b) have a "well-defined weakness . . . that jeopardize(s) the liquidation of the debt"; and

(c) be characterized "by the distinct possibility that the bank will sustain some loss."

The Comptroller's Handbook for National Bank Examinations contains the same definition of "substandard" with one additional sentence . . .

> "Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified 'substandard'."

Joint Statement of the Federal Regulatory Agencies on Their Agricultural Credit Policy

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System (FRS) and the Farm Credit Administration (FCA) -- which regulates the farm credit system -- are reinforcing their long standing policy of encouraging banks and associations to work with farmers and small business borrowers who are experiencing temporary difficulties in meeting their debt service obligations. The regulators believe this policy is prudent provided the institutions' practices are generally consistent with safety and soundness considerations.

This statement of the agricultural credit policy of the Federal regulatory agencies is being provided to all examiners. This, along with other policy statements and regular training seminars on agricultural credit arranged for the examiners, is designed to ensure that farm credit problems will be handled with understanding.

All four regulatory agencies have recently emphasized to their examination staffs that although it is the responsibility of an examiner to point out to management the weaknesses which may be present in loans, the regulatory agencies do not require foreclosing or calling loans. Borrowers who are experiencing problems should work with their lenders, since they are the ones responsible for granting, restructuring and collecting loans. Lenders, farmers and regulators have a mutual interest in the long term success of the local farm economy.

The FRB, OCC, FDIC and FCA examiners, when analyzing a credit, consider the source of repayment, the adequacy of collateral and the ability of the borrower to repay the loan as the primary factors in assessing the quality of a loan. Generally, if a farmer is making cash payments to keep his debt service payments current and the lender and the examiner believe the farmer is able to continue to make timely debt payments, the loan will be considered a satisfactory loan, even if surrounding land values have fallen significantly, and, therefore, the farmer's financial position may not be as strong as it was when the loan was made.

As has been the long standing practice of the regulators, experienced review examiners in the regional offices will continue to analyze the examination reports submitted by examiners to ensure that they are in conformance with the above policies prior to their transmittal to the banks and associations. Before leaving each lending institution, the examiners will discuss their report findings with the management to make sure there is no misinformation regarding the institution's credit policies and procedures or loan classifications. Should a lender have additional questions or comments about the examination report, the lender may seek a formal review of the matter with the local regulatory agency office.

Over the past several years, some farmers and farm sector borrowers have been subject to financial pressures resulting from depressed commodity prices, declining land values and the aftermath of drought. These financial pressures have resulted in increased delinquent loans in the portfolios of agricultural sector banks and associations. Some of these problems are transitory and it is reasonable to expect that the borrowers will be able to resume payments when economic conditions in the agricultural sector improve. Examiners will keep in mind that, under such circumstances, agricultural lenders may find that the most prudent policy is to stretch out payments rather than to take more precipitous action such as foreclosure and/or forcing a borrower into bankruptcy. Such a policy does not alter requirements on the recognition of loss loans or the accounting treatment of nonperforming or nonaccrual assets by financial institutions.

Senator GORTON. Senator Grassley, thank you very much. There's no member of this body who works more diligently for his constituents or more imaginatively in coming up with solutions to problems than you do. You are invited to stay and to listen to and to question any of the other witnesses who will be here if you desire to do so. In any event, we do appreciate your testimony.

Senator GRASSLEY. Thank you. I really hope this will help to get these bank examiners out there in Iowa to be a little more forbearing.

Senator GORTON. Thank you.

Mr. Partee, you have been sitting here for quite sometime now. I will say to you and to the two members of panel 2, that we want you to limit your testimony to not more than 10 minutes. We have your written testimony. You can paraphrase it if you will. To the panelists on panels 3 and 4, to 5 minutes of formal testimony each, so that we will have time for questions.

With that, Mr. Partee, welcome to the committee.

STATEMENT OF J. CHARLES PARTEE, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. PARTEE. Thank you, Mr. Chairman and Mr. Dixon. I will abbreviate my testimony.

I am happy to be here today to discuss the current difficulties being experienced by banks in our agricultural communities. As members of this committee are well aware, these problems have been intensifying.

ORIGIN OF FARM PROBLEMS

The origin of these problems can be traced to the 1970's. Our farm sector experienced a major boom during that decade and many farmers expected the good times to continue in the 1980's. Acting on these expectations, farmers and other investors acquired additional farm land, bidding up its price in the process. Farmers also invested heavily in new machinery and equipment. Moreover, many thought it advantageous to finance a relatively large share of these investments with borrowed money. Consequently, farm debt surged, rising, after allowance for inflation, about 60 percent from 1971–79.

As it turned out, the agricultural boom of the 1970's gave way to a bust in the 1980's. The high farm prices of the 1970's attracted additional resources into agriculture both here and abroad, so that by the start of this decade, the potential for farm production had increased considerably. At the same time, growth in demand for American agricultural products weakened. Farm exports in particular have been reduced by sluggish economic conditions abroad and the high exchange value of the dollar, as well as by the expanded ability of other nations to meet consumption needs from their own internal production. These market developments have kept farm prices persistently depressed. As a result, farm income has been low for 5 years in a row, and land values have been declining since 1981.

Farm debt, though no longer increasing, still is high; and interest rates on farm loans, while down from earlier levels, remain well

above those prevailing in the last decade when much of the debt was incurred. Thus, many farmers are faced with the problem of servicing a large volume of debt, at relatively high interest rates, with a substantially reduced level of farm earnings.

Estimates indicate that perhaps a third of the full-time producers on commercial-sized family farms have debt burdens large enough to cause moderate to severe financial stress, and this group owes about two-thirds of all farm debt. The greater proportion of this debt is owed to the farm credit system, the Farmers Home Administration, and individuals. About one-quarter of total farm credit is provided by commercial banks.

The banks experienced only minimal problems in their farm loan portfolios during the 1970's, but such problems began to pick up in 1981 and have been increasing steadily since then. At the end of 1984, nonaccrual farm production loans at all banks in the Nation totaled about $1.5 billion, and other nonperforming loans—those past due 90 days or more but still accruing interest, plus renegotiated troubled loans—totaled about $0.5 billion. Another $1 billion of farm production loans were past due 30 to 89 days. Altogether, these poor performing and nonperforming loans constituted about 7.5 percent of all farm production loans.

In addition, net chargeoffs of farm loans at all commercial banks are estimated to have been about $900 million in 1984, or a bit more than 2 percent of outstandings.

Last year's high chargeoffs and an increase in provision of loan loss reserves has depressed the profitability of many agricultural banks. On average, returns on equity fell to 9 percent last year, down from returns averaging between 14 and 16 percent in every year from 1973 through 1982. There was great variation in earnings recorded among agricultural banks, however, mainly reflecting a sharp difference in loan loss experience. Thus, 12 percent of these banks reported negative earnings last year, and another 9 percent recorded only minimal positive earnings. At the same time, over half earned over 10 percent on equity, and nearly one-fifth over 15 percent.

In the aggregate, earnings of agricultural banks were high enough to permit a further buildup in the average capital ratio, and the capital ratios of most agricultural banks remain high relative to those at nonfarm banks. But a small but troubling number of farm banks experiencing relatively high loan losses have suffered an erosion of their capital base, thus increasing their vulnerability to failure should losses continue.

FARM BANK FAILURES CLIMB

Last year, 32 agricultural banks failed, mostly in the second half of the year, compared with only 7 in 1983. Many of these banks came from a group that had reported delinquent loans at the beginning of the year in excess of the capital of the bank, and the number in this condition rose further during 1984. At 102 agricultural banks, nonperforming loans at the beginning of this year exceeded total capital, up from 44 a year earlier. At 240 agricultural banks, the combined sum of past due and nonperforming loans exceeded total capital, up from 133 a year earlier. Thus, agricultural

bank failures seem likely to rise further in 1985. So far we have had 17.

That the great majority of our farm banks remain in relatively strong condition after 5 years of depressed conditions in the agricultural sector is a tribute to their management. These banks generally followed prudent standards in extending credit to their farm customers during the boom times of the 1970's, standards which tended to hold down the degree of leveraging permitted individual customers—and in the process helped to keep farmers from becoming overextended. In addition, many farm banks followed policies that permitted them to maintain reasonably diversified asset portfolios.

The management policies and practices of banks, of course, tend to vary along a continuum. Thus, the longer conditions in the agricultural sector remain depressed, the greater will be the number of banks experiencing problems of greater severity. Since no dramatic change appears likely in the current balance between supply and demand for farm products, such trends seem almost certain to continue for some time to come.

The Debt Adjustment Program, first announced by the administration last September and then modified in mid-March, offers farm banks and their farm customers some assistance in moving through this difficult transition period. As you know, under this program the Government will guarantee most of the remainder of a troubled farm loan after the lender reduces the principal amount, or an equivalent in interest 10 percent or more. As of April 15, the Farmers Home Administration had received only 401 applications for such guarantees, and had guaranteed 129 loans totaling $19.5 million. The flow of applications has been increasing gradually, though, and it seems to me quite reasonable to expect banks and their farm customers to make greater use of these guarantees with the passage of time. I understand also that the Farmers Home Administration, under its regular loan guarantee program, this year has guaranteed a substantially larger volume of farm operating loans than in recent preceding years.

The Federal Reserve has revised and extended its seasonal lending program with the objective of making sure that agricultural banks will have sufficient liquidity to provide needed production loans to their farmer customers. The regular seasonal program, in place since 1973, was liberalized to increase the portion of seasonal funding needs that the Fed stands ready to supply to small- and mid-sized institutions. In addition, a new temporary simplified seasonal program is aimed particularly at smaller banks substantially involved in agricultural lending.

The Federal Reserve, as well as the other Federal banking agencies, has also recently reiterated its policy of instructing bank examiners to refrain from taking supervisory actions that would discourage banks from exercising appropriate forbearance when working with farmers or other small businesses with delinquent loans. It is not the intent of this policy to encourage or permit loan decisions that are inconsistent with a bank's long-term safety and soundness. The policy recognizes however, that if there is good reason to believe a borrower's difficulties are temporary in nature, it is also prudent banking policy to extend due dates on his loans,

and in some cases to grant additional credit to carry him over a period of distress. Reserve banks have designated senior review examiners with expertise in supervising farm banks to oversee the administration of this policy.

EXTENSION OF NET WORTH ASSISTANCE PROGRAM

Mr. Chairman, you asked me to comment today on proposed legislation that would extend the Net Worth Assistance Program to farm banks. Under this program, the FDIC would stand ready to swap its promissory notes for the net worth certificates of those farm banks whose capital positions have fallen below regulatory standards and have suffered negative earnings in two preceding quarters. The swap is supposed to be reversed when the institution regains its health. While no new funds or permanent capital are provided by this program, it would permit an institution to continue operating with a level of stockholder equity below that which regulatory agencies ordinarily require. In addition, it would provide some reassurance to the holders of uninsured liabilities of troubled banks.

At present, the coverage of this proposed program would be quite limited, though growing, since the vast majority of farm banks remain well capitalized and have positive earnings. Moreover, there are other important drawbacks to be considered. As presently formulated, the program would provide aid to a bank regardless of whether its problems are temporary or permanent in nature. If the latter, a clearly better approach would be to achieve an immediate shift of its resources to a healthy, better run institution. But wherever significant loan losses must be taken and capital thus eroded, it would be better for an institution's capital base to be augmented with new permanent funding sources rather than with temporary accounting capital that would have to be replaced over time through the retention of future earnings.

On balance, I can see relatively little long-term advantage in the net worth assistance proposal barring a further substantial deterioration in the condition of farm banks that reaches systemic proportions. Presently, in cases where loan losses are sufficient to undermine seriously a bank's capital position, I would prefer to encourage and facilitate mergers with stronger banking institutions, particularly those not now so heavily involved in agricultural lending. That would offer several important advantages. First, it would transfer control of the institution's lending resources to a bank with a better management record. Second, it would provide an infusion of real, permanent capital into the bank and thus into agricultural lending in general, rather than a temporary provision of unusable accounting capital as would occur with net worth certificates. Finally, mergers with banks outside the community of agricultural banks would promote greater diversification of portfolio risk.

There is no doubt that the agricultural sector has been going through some very hard times because of unanticipated weakness in farm product markets, markets that will no longer support the built-in structure of high indebtedness. Many banks that have concentrated their lending in the farm area thus are encountering dif-

ficulty, and it may well be that more will be driven to the point of bankruptcy. But, as I see it, the best way to deal with an erosion of capital is to obtain replacement funds from present or prospective bank owners. And where the bank's problems appear too severe or fundamental to handle in this manner, the best solution is to seek mergers with other institutions that promise a larger, more stable, lending and deposit base.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT BY

J. CHARLES PARTEE

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I appreciate the opportunity to appear before this committee to discuss the current difficulties being experienced by banks in our agricultural communities. As members of this Committee are well aware, these problems have been intensifying lately, as more farmers have been finding it difficult, if not impossible, to meet fully the contractual terms of their loan obligations.

The origin of these problems can be traced to the 1970s. Our farm sector experienced a major economic boom during that decade, and many farmers expected the good times to continue in the 1980s. There was, in particular, a general perception that there were limits on potential world production of agricultural products and that this would continue to encourage a rapid growth in farm exports, thus fostering increasing returns to land and other farm inputs. Many also believed the more rapid inflation of the decade would persist, so that long-term indebtedness could be paid off with less valuable future dollars. Acting on these expectations, farmers and other investors acquired additional farm land, bidding up its price in the process. Farmers also invested heavily in new machinery and equipment. Moreover, in view of the apparently favorable outlook for agriculture and, for most of the decade, of interest rates that were low relative to the expected rise in income and asset prices, many thought it advantageous to finance a relatively large share of these investments with borrowed money. Consequently, farm indebtedness surged, rising, after allowance for inflation, about 60 percent from 1971 to 1979.

As it turned out, however, the agricultural boom of the 1970s gave way to a bust in the 1980s. The high farm prices of the 1970s attracted additional resources into agriculture both here and abroad, so that by the start of this decade, the potential for farm production had increased considerably. At the same time, growth in demand for American agricultural products weakened. Farm exports in particular have been reduced by sluggish economic conditions abroad and the high exchange value

of the U.S. dollar, as well as by the expanded ability of other nations to meet consumption needs from their own internal production. These market developments have kept farm prices persistently depressed. As a result, farm income has been low for five years in a row, and land values have been declining since 1981.

Farm debt, though no longer increasing, still is high; and interest rates on farm loans, while down from earlier levels, remain well above those prevailing in the last decade when much of the debt was incurred. Thus, many farmers are faced with the problem of servicing a large volume of debt, at relatively high interest rates, with a substantially reduced level of farm earnings. High interest rates and reduced income flows also have added to the downward pressure on land values, thus further limiting the farmers' ability to pay down debt by selling these assets.

The earnings of all farmers have been adversely affected by lower product prices, but not all are experiencing the same degree of financial stress. Farmers that are relatively debt-free have suffered declines in asset values but are not in danger of falling into insolvency. In contrast, producers who entered the 1980s with only a relatively small equity cushion have been experiencing increasing financial difficulties. Estimates indicate that perhaps a third of the full-time producers on commercial-sized family farms have debt burdens large enough to cause moderate to severe financial stress, and this group owes about two-thirds of all farm debt. The greater proportion of this debt is owed to the Farm Credit System, the Farmers Home Administration and individuals. Nonetheless, about one quarter of total farm credit is provided by commercial banks, and a sizable proportion of the farm loan portfolios of many banks have become troubled to a greater or lesser degree.

Commercial banks experienced only minimal problems in their farm loan portfolios during the 1970s. Such problems began to pick up in 1981 and have been increasing steadily since then. One indication of the deterioration in the quality of

agricultural loans at banks that has occured since then is provided by data on delinquencies and charge-offs. While not all banks are required to report such data for their farm loans, from available information our staff estimates that at the end of 1984 nonaccrual farm production loans at all banks in the nation totaled about $1.5 billion, and other nonperforming loans--those past due 90 days or more but still accruing interest, plus renegotiated troubled loans--totaled about $0.5 billion. In addition, about $1.0 billion of farm production loans were past due 30 to 89 days. Altogether these poor performing and nonperforming loans constituted about 7-1/2 percent of all farm production loans.

In addition, net charge-offs of farm loans at all commercial banks are estimated to have been about $900 million in 1984, or a bit more than 2 percent of outstandings. Of this total, $240 million was reported by banks in California, representing about 6 percent of their outstanding farm loans. While California banks led the nation in charge-offs, these losses presented less of a problem for them than for banks in many other states. This was because most of the losses were booked by major banks with large branching systems, where agricultural loans constituted a relatively small proportion of their total asset portfolios. In contrast, many banks operating in agricultural areas of states that limit branching--states found mainly in the midwest--have had more trouble accommodating to their loan losses because of the high concentration of these loans in their asset portfolios.

Last year's high charge-offs and an increase in provision of loan loss reserves had a marked depressing effect on the profitability of many agricultural banks (banks at which the ratio of farm loans to total loans exceeds the average of such ratios at all banks, currently about 17 percent). On average, returns on equity fell to 9 percent, down from returns averaging between 14 and 16 percent in every year from 1973 through 1982. There was great variation in earnings recorded among

agricultural banks, however, mainly reflecting a sharp difference in loan loss experience. Thus, 12 percent of these banks reported negative earnings last year, and another 9 percent recorded only minimal positive earnings. At the same time, over half earned over 10 percent on equity, and nearly a fifth over 15 percent.

In the aggregate, earnings of agricultural bank were high enough to permit a further buildup in the average capital ratio of these banks, and the capital ratios of most agricultural banks remain high relative to those at nonfarm banks. But more farm banks seem certain to come under financial strain, if farm loan losses continue and intensify. Moreover, as I have noted, a small but troubling number of farm banks experiencing relatively high loan losses have already suffered an erosion of their capital base, thus increasing their vulnerability to failure should such losses continue.

Such extremely adverse results have been occurring in small but increasing numbers. Last year, 32 agricultural banks failed--mostly in the second half of the year--compared with only 7 in 1983. Many of these banks came from a group that had reported delinquent loans at the beginning of the year in excess of the capital of the bank. Unfortunately, the number of agricultural banks in this condition, while still a relatively small proportion of the 5,000 agricultural banks, rose further during 1984. At 102 agricultural banks, nonperforming loans at the beginning of this year exceeded total capital, up from 44 a year earlier. Moreover, at 240 agricultural banks, the combined sum of past due and nonperforming loans exceeded total capital, up from 133 a year earlier. Thus agricultural bank failures seem likely to rise further in 1985--indeed 17 farm bank failures already have occurred.

To sum up the current situation, while the incomes of the great bulk of our farmers have been reduced since the beginning of this decade, those that got heavily into debt in the 1970s are primarily the ones experiencing serious financial strains, with the severity of these strains increasing with the degree of their leveraging. While

such farmers constitute only about one-third of all farmers, they account for about two-thirds of all agricultural debt. As many of these borrowers have found it increasingly difficult to service their loans, banks and other agricultural lenders have been encountering increasing problems. To date, information suggests that the great majority of farm banks remain in good condition despite these problems, but a significant and growing number is experiencing an increasing degree of strain.

That so many of our farm banks remain in relatively strong condition after five years of depressed conditions in the agricultural sector stands, I believe, as a tribute to their management. What this rather clearly suggests is that these banks generally followed prudent standards in extending credit to their farm customers during the boom times of the 1970s, standards which tended to hold down the degree of leveraging permitted individual customers--and in the process helped to dampen tendencies for these customers to become over extended. In addition, many farm banks followed policies that permitted them to maintain reasonably diversified asset portfolios.

Banks that failed to adhere to high standards of quality and asset diversity have been considerably more vulnerable to the effects of deteriorating circumstances of agricultural borrowers. One can point to situations in which a bank that is failing or in extremely troubled condition is located in close proximity to one or more other banks that remain in good condition. In addition, I understand that the FDIC, in a study it conducted of the banks that failed in 1984, found evidence of various kinds of abusive practices, including improper insider transactions, instances of possible fraud, and other forms of irregular management activities.

The management policies and practices of banks, of course, tend to vary along a continuum. Thus, the longer conditions in the agricultural sector remain depressed, the greater will be the number of banks experiencing problems of greater

severity. As I have noted, that process is already quite observable in the trends of recent years. Since no dramatic change appears likely in the current balance between supply and demand in agricultural markets, such trends seem almost certain to continue for some time to come. Put more directly and graphically, it seems quite possible that many more agricultural banks and their farmer customers will experience severe financial dislocations over the next several years. I should hasten to add that at present it still appears that the great bulk of farmers and of farm banks have sufficient financial strength to weather these conditions, although admittedly not without growing strains and problems.

The debt adjustment program, first announced by the Administration last September and then modified in March, will offer farm banks and their farmer customers some assistance in moving through the difficult transition period that appears to lie ahead. As Committee members know, under this program the government will guarantee most of the remainder of a troubled farm loan after the lender reduces the principal amount (or an equivalent in interest charges) 10 percent or more as needed to reduce the borrower's debt service burden to a level that he appears able to handle. As of April 15, the Farmers Home Administration had received only 401 applications for such guarantees, and had guaranteed 129 loans totaling $19.5 million. The flow of applications has been increasing gradually since the program was revised on March 13, however, and it seems quite reasonable to expect banks and their farm customers to make greater use of these guarantees, if problems in the agricultural sector persist. I understand also that the Farmers Home Administration, under its regular loan guarantee program, this year has guaranteed a substantially larger volume of farm operating loans than in preceding years.

The Federal Reserve also revised and extended its seasonal lending program in March of this year with the objective of making sure that agricultural

banks will have sufficient liquidity to provide needed production loans to their farmer customers. The regular seasonal program, in place since 1973, provides discount window credit to depository institutions with limited access to national money markets that experience recurring seasonal swings in net needs for funds because of the way their deposit flows fluctuate relative to their loan demands. This existing program was liberalized to increase the portion of the seasonal funding needs that the Federal Reserve stands ready to supply to small and mid-sized institutions. In addition, a temporary simplified seasonal program has been established as an alternative source of seasonal credit. Aimed particularly at smaller banks substantially involved in agricultural lending, this program offers institutions with total loan growth above a base amount of two percent the opportunity to fund half of any further loan expansion through discount window loans, up to a maximum amount of five percent of the institution's total deposits.

In announcing the broadening of its seasonal credit program, the Federal Reserve noted that there were few if any signs to indicate that agricultural banks generally would experience any unusual shortfall of liquidity. The action was taken, nevertheless, to have in place a means to offset any unforeseen liquidity strains that might arise in local areas or for individual banks, thus threatening the necessary flow of credit to farmers. Thus far, total borrowing in our seasonal program has been running somewhat below last year's levels. But seasonal credit needs normally continue to expand through the spring and summer and may yet begin to outpace the available liquidity of some farm banks.

The Federal Reserve, as well as the other federal banking agencies, has also recently reiterated its policy of instructing bank examiners to refrain from taking supervisory actions that would discourage banks from exercising appropriate forbearance when working with farmers or other small businesses with delinquent

loans. It is not the intent of this policy to encourage or permit loan decisions that are inconsistent with a bank's long term safety and soundness. The policy recognizes, however, that if there is good reason to believe a borrower's difficulties are temporary in nature, it is prudent banking policy to extend due dates on his loans, and in some cases to grant additional credit to carry him over a period of distress. Reserve Banks have designated senior review examiners with expertise in supervising farm banks to oversee the administration of this policy.

Mr. Chairman, I was asked to comment today on another proposal for assisting troubled agricultural lenders. Legislation has been introduced that would extend the Net Worth Assistance Program--currently targeted to provide assistance to real estate lenders with low capital and weak earnings--to farm banks. Under this proposed program, the FDIC would stand ready to swap its promissory notes for the net worth certificates of those farm lenders whose capital positions have fallen significantly below regulatory standards and have suffered negative earnings in two preceding quarters. The swap is supposed to be reversed when the institution regains its health. While no new funds or permanent capital are provided by this program, it would permit an institution to continue operating with a level of stock holder equity below that which regulatory agencies ordinarily require. In addition, since the FDIC's promise would be a general asset of the bank and thus available to meet the demands of depositors and other creditors in the event the bank is liquidated, it would provide some reassurance to the holders of uninsured liabilities of troubled banks.

At present, the coverage of this proposed program would be quite limited, since the vast majority of farm banks remain well capitalized and have positive earnings. Moreover, while the number of banks that would be eligible for the program seems likely to grow, there are other important drawbacks to be considered. As presently formulated, the program would provide aid to a bank regardless of whether

its problems are temporary or permanent in nature. If the latter, a clearly better approach would be to achieve an immediate shift of its resources to a healthy, better run institution. In addition, in cases where significant loan losses must be taken and capital is thus eroded, it would be better for an institution's capital base to be augmented with new permanent funding sources, rather than with temporary accounting capital that would have to be replaced over time by the retention of future earnings.

Taking these points into consideration, I can see relatively little long-term advantage in the net worth assistance proposal, barring a further substantial deterioration in the condition of farm banks that reaches systemic proportions. Presently, in cases where loan losses prove enough to undermine seriously a banks' capital position, I would think it better to encourage and facilitate mergers with stronger banking institutions, particularly those that are not now so heavily involved in agricultural lending. That would offer several important advantages. First, it would transfer control of the institution's lending resources to a bank with a better management record. Second, it would provide an infusion of real, permanent capital into the bank and thus into agricultural lending in general, rather than a temporary provision of "accounting" capital as would occur with NWA certificates. Finally, mergers with banks outside the community of agricultural banks would promote greater diversification of portfolio risk. In this way, the banking system would come to be better protected against unforeseen developments that, from time to time, adversely affect the financial health of different sectors of the economy.

There is no doubt that the agricultural sector has been going through some very hard times because of unanticipated weakness in farm product markets that will no longer support the built-in structure of high indebtedness. Many banks that have concentrated their lending in the farm area thus are encountering difficulty because of the inability of farmers to service their debts, and it may be that more will be driven

to the point of bankruptcy. But, as I see it, the best way to deal with an erosion of capital is to obtain replacement funds from present or prospective bank owners. And where the bank's problems appear too severe and fundamental to handle in this manner, the best solution is to seek mergers with other institutions that promise a larger, more stable, lending and deposit base.

Senator GORTON. Mr. Partee, thank you.

Do you think that the Federal Government should do anything now other than to assist in finding merger partners for failing banks?

Mr. PARTEE. Well, I cited several programs now available. One is the Farmers Home Administration Guarantee Program, which I think is a good instrument for assisting the cases where banks have loans which are in trouble but are not so bad that it's impossible to save them.

Second, we have the Federal Reserve program which will provide agricultural banks with liquidity. In cases where they need it, just as was done with Continental.

And third, we have the forbearance policy, with respect to farm loans which is the same policy we exercise with respect, say, to Latin American loans.

So there are several programs to assist banks with troubled farm loans, and I think, given what seems to be the extent of the current problem, they are at this time sufficient.

Senator GORTON. Would you encourage agricultural States to adopt statewide branching laws to allow diversification of portfolios?

Mr. PARTEE. I think it is important to get broader institutions that have a wider variety of assets.

DIVERSIFICATION

As I mentioned in my testimony, farm loan losses in California last year were quite disproportionately high compared to those in the Middle West, but the California banks survived because they are statewide systems with much diversification. So I think that is a desirable way to go.

Senator GORTON. Have you made that point to any of these agricultural States? Does the Fed speak to their Governors, or banking regulators, or legislators?

Mr. PARTEE. Well, I think our recognition that larger banking systems are in the cards has been well recorded and in fact was a subject of testimony by Chairman Volcker 2 days ago.

Senator GORTON. How serious are the local credit availability problems when an agricultural bank fails? How many of the failures involve just the total closure of a bank as opposed to an assisted merger?

Mr. PARTEE. I think almost all of them are assisted. You have a representative from the FDIC that can speak to that. They've had relatively few outright closings of bank facilities.

There may be discontinuity for some borrowers when their bank fails. Ordinarily the merger is of what they call a clean bank, with the FDIC keeping and then liquidating the unwanted portfolio of the failing bank, and there may be some discontinuity involved in that. But banking services are still available in the community, and I would think that the acquiring bank would be interested in making local loans to good customers.

Senator GORTON. You heard Senator Grassley criticize some of the processes of bank examiners while he was sitting next to you. Now much of that criticism has been aimed at the OCC and the FDIC.

Does the Fed have any different examination or classification standards?

Mr. PARTEE. No; I think our procedures are the same. We have now all adopted a formal policy of forbearance and I must admit that I haven't heard much criticism of Federal Reserve examinations of agricultural banks.

Now, far fewer banks are directly regulated by us than is the case with the other agencies, but we do have 1,100 State member banks, of which about 250 are agricultural, and there's been relatively little difficulty.

I would point out, Senator, that you obviously have a situation of confrontation, and one in which judgment is important and emotions run high, when an examiner wishes to classify the banker's assets because he thinks they're not too good. I mean, there's a natural tendency in that case to get accusations flying back and forth.

Senator GORTON. Does the Federal Reserve Board require that all loans of the same borrower be classified in the same way on examination?

Mr. PARTEE. Yes; and as I said, in our forbearance policy, we have designated review examiners at the Reserve Banks to check each field examination of an agricultural bank to see that it has been handled appropriately and uniformly.

Senator GORTON. You also heard Senator Grassley compare the nature of the problems and the Federal attention given to agricultural banks, to international lending, and to Continental Illinois.

In my own State, for example, we've had problems with fishing and forestry, as well as with agriculture. We could add to the names of the banks utilized here today Penn Square, Sea First, in my State, and the like.

Would you comment on the relative magnitude of the problems in the agricultural sector with respect to energy and some foreign loans and some of the rest of the matters which have been discussed here today?

Mr. PARTEE. Well, it's a little difficult to do. I would comment that I think that we in Washington are giving a good deal of attention to the farm credit problem as it pertains to our various activities. Maybe the problem hasn't been given quite the attention in the newspapers as have those of Argentina or Continental but the problem is receiving our attention and we have what I consider to be quite comparable policies in each of these areas.

For example, with respect to less developed countries [LDC] loans, our policy is forbearance. That is, where there is a prospect, some prospect of repayment, we do not discourage the banks from

forbearing—exactly the same as our policy with regard to agricultural loans and agricultural banks.

With regard to Continental, we put $8 billion into Continental last year about this time, as it had a major deposit outflow—a run on deposits. We would do that for any farm bank in the country and have done it, and did it a few weeks ago in Ohio for savings and loans that suffered outflows of funds. So I don't see any difference in our policy with regard to farm banks and city banks in that respect.

There seems to be some feeling—and this is more of an FDIC matter than mine—that somehow Continental was bailed out, but I consider that what was done there was the functional equivalent of a failure. The management was removed. The board of directors was removed. Four-fifths of the stockholders' equity was taken away. I didn't hear that being proposed for farm banks by Senator Grassley, as the counterpart activity.

So I think there's some tendency—you have to try to be objective and see what the relative treatment really has been.

We had a very serious problem with energy loans and we've had quite a few banks, probably more—certainly more in total dollar volume—fail because of energy loan problems than farm credit problems. But it's much the same kind of a problem.

In the energy case, everybody thought that oil and gas prices were going to skyrocket and you couldn't lose by investing in energy. The banks agreed and the banks put their money into energy loans; they were wrong and they lost.

In agriculture, everybody thought in the 1970's that the boom would continue—that there wasn't going to be enough food, that there would be shortage of production. And so the farmers and investors put their money into farms and the bankers agreed and put their money into farm loans, and they are losing. It's much the same kind of situation.

Senator GORTON. Senator Cranston has joined us. Do you have a statement or any questions?

Senator CRANSTON. No. I welcome the witnesses. I have no questions.

Senator GORTON. Thank you.

Thank you very much, Mr. Partee. We appreciate your help.

[Additional remarks supplied for the record by J. Charles Partee follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

J. CHARLES PARTEE
MEMBER OF THE BOARD

May 17, 1985

The Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Gorton:

Thank you for your letter of May 1 requesting my comments on Senator Sasser's proposals to assist small agricultural banks and their farm customers. I understand that Senator Sasser is contemplating introducing legislation which embodies these proposals under the title, the Farm Credit Relief Act of 1985.

The Senator seeks to assist targeted banks--those located in agricultural trade areas that have total assets of less than $200 million (25 percent of which are agricultural loans) and whose problems are not due to fraud or mismanagement--in two ways. First, such banks that own buildings or equipment with a fair market value in excess of book value would be allowed to revalue the latter to the level of the former and thus raise the bank's book capital position. The objective is to enable a bank to gain "additional" book capital without going through the expensive process of selling such assets--to obtain a capital gain--and then leasing them back.

Second, qualified banks with eligible agricultural loans would be authorized to offer their customers the opportunity to renegotiate these loans. (To be eligible, a loan would have to be secured by farm land or farm machinery or be a loan to an agri-business or one that is deemed eligible in order to allow a qualified bank to remain viable.) The renegotiation would involve writing the loan down to the current market value of the collateral securing it and establishing terms for the payment of interest and repayment of the revalued principal that are commensurate with the farmer's ability, based on his prospective net cash flow, to make these payments. It is contemplated that these renegotiated loans would have a maturity of no longer than ten years but, in certain cases, would have a "balloon" final payment in order to cut down on the farmer's cash

outlays over the interim period. The bank would be permitted to write off its losses on the renegotiated loans by charges to future earnings over a 30-year period.

The problems that have prompted Senator Sasser to set forth his proposals are, indeed, serious. As I indicated in my recent testimony, the agricultural sector has been going through some very hard times and, as a result, a growing, although still relatively small, number of agricultural banks have been encountering increasing difficulties. But while I agree with Senator Sasser on the need to seek a solution to these problems, it seems to me unlikely that his plan will accomplish this task in an appropriate and effective way.

Of his two basic proposals, I have less difficulty with the one that would permit a bank to achieve an increase in book capital by raising the book value of its assets that have a higher fair market value. As Senator Sasser has pointed out, some banks are already attempting to achieve this objective at significant expense by selling assets undervalued on their books and then leasing them back. Thus, there is some basis for supporting a proposal that would allow a bank to accomplish the same end without incurring the expense involved. Nonetheless, I have considerable reservation about the wisdom of such an approach. In the first place, the write-up of asset value would be based on a subjective asset appraisal rather than an actual transaction, and this would seem to create the obvious danger that unwarranted values might be agreed to. In the second place, as is the case with all proposals that would allow a selective writing up of the book value of assets to their higher market values without requiring the writing down of other assets to their lower market values, the proposal would work to undermine the integrity of accounting reports and the public's confidence in financial statements.

I have greater problems concerning the second proposal. Only a relatively small number of banks would qualify for the assistance, because most farm banks remain in relatively healthy condition and because some of those that are experiencing strains have problems that can be traced to substantial mismanagement and so would not be eligible to receive assistance under the criteria specified in the proposal. More importantly, those that would qualify would not be assisted in any fundamental way.

While stretching out the write-off of loan losses to a 30-year period might tend to keep the book value of capital up in the initial years, it would do very little to help maintain the earnings of the bank. Interest income, after all, would be earned only on the amount of loans reduced by renegotiation, while interest costs would have to be paid on unreduced deposit liabilities. Thus, the earnings of banks with a significant volume of renegotiated loans would be squeezed both by an interest margin shortfall and by the need to provide gradually out of earnings for the losses booked under the program. I might also note that my objection to the proposal discussed above--that it affects the integrity of accounting reports--would apply equally to this proposal.

A temporizing action that would help to sustain reported bank capital might be justified if one could be certain that the credit problems found are only temporary in nature. The situation facing farmers, and thus some of the banks that finance their operations, reflects to an important degree the expansion of world supplies of farm products relative to demands for these products. Plans that permit farm banks to avoid "recognizing" a fundamental problem through use of "innovative" accounting techniques may not be helpful to these banks if the problem proves to be long-lasting. I believe it would be far better in these circumstances to seek a permanent solution to a troubled bank's problems by obtaining new capital from present or prospective owners; or, if a bank's problems are too severe, to merge it with other stronger institutions.

I hope these comments are useful to you. Please let me know if I can be of further assistance.

Sincerely,

/s/

Our next panel will include Margaret Egginton and Frank Naylor. Mrs. Egginton, you may proceed.

STATEMENT OF MARGARET L. EGGINTON, DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mrs. EGGINTON. Thank you, Mr. Chairman, Senator.

I am pleased to be here to give the FDIC's views on the subject of net worth certificates for agricultural banks.

Although my statement is brief, I would like to dispense with reading it.

Senator GORTON. We would appreciate that.

Mrs. EGGINTON. But I would ask that the entire statement be included in the record.

Senator GORTON. It will be included in the record in its entirety.

Mrs. EGGINTON. Thank you.

Before responding to your questions, I'd like to emphasize a couple of points that I made in my prepared statement.

NO REAL CRISIS

First, while there may well be a problem of crisis proportions in agriculture—and Mr. Naylor I assume will address that—in our judgment, there is no crisis among agricultural banks.

A number of agricultural banks are feeling the effects of the problems in agriculture, but throughout the system it cannot be said that there is a crisis.

For that reason, we don't believe that a program of net worth assistance is needed. Indeed, we believe it would be harmful.

The only circumstances under which we believe such a program might be useful would be if the agricultural banking industry does experience problems of crisis proportions. Should that ever come to pass, the FDIC believes it has the authority and the tools to deal with it.

Second, as I noted in my statement, we are opposed to a program of net worth assistance for agricultural banks because we believe it doesn't address the problem and indeed would be harmful. We believe that seeking healthy banks to acquire banks in danger of failing in agricultural communities is a far better alternative to a paper prop up of these crippled banks. A solution that brings new and fresh real capital into those banks is a better one for the long-range health of the industry and for the communities those banks serve.

That is, in brief, our position on net worth assistance and I would be happy to respond to any questions that my statement may have raised.

[The complete prepared statement follows:]

STATEMENT ON

NET WORTH CERTIFICATES FOR
AGRICULTURAL BANKS

PRESENTED TO THE

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND CONSUMER AFFAIRS

BY

MARGARET L. EGGINTON
DEPUTY TO THE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

9:30 a.m.
Friday, April 26, 1985
Dirksen Senate Office Building, Room SD-538

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to express the FDIC's views on the use of net worth certificates to augment capital in agricultural banks.

The FDIC is acutely aware of the problems in the agricultural sector, particularly the circumstances facing banks. Many of the approximately 9,000 banks under the FDIC's direct supervisory jurisdiction are agricultural banks; they are for the most part located in the midwest and are under $100 million in size. Through its supervision of these banks over the years, the FDIC has built substantial examiner expertise in evaluating agricultural loans and has become highly knowledgeable about the challenges posed to agricultural banks during both good and bad times.

The FDIC has been making a special effort to assist states with acute agricultural problems. For example, we have provided technical assistance and personnel to Iowa and Nebraska in handling failed financial institutions that were not covered by federal deposit insurance. We also have expedited the processing of applications for deposit insurance for new banks and existing non-insured banks from those states so that adequate banking facilities could be afforded smaller communities.

Because of our longstanding and intimate familiarity with small rural banks, the FDIC is sympathetic to the current distress of many farm bankers. Nevertheless, the FDIC has in no way caused or contributed to the problems and, by itself, can do little to cure them. Our policy is to evaluate realistically and fairly the condition of farm banks and farm credits. We will continue that policy. We will also participate in initiatives to aid in the recovery of the agricultural sector consistent with our mission of ensuring the safety and soundness of the banking system.

Among the proposals to help alleviate the agricultural situation is a net worth certificate program for agricultural banks like the existing net worth assistance program for thrifts. The FDIC firmly opposes such a program for commercial banks with agricultural loan problems. It would do nothing to solve the problems and would, in fact, be harmful to the FDIC, the banking industry and the communities involved.

Proponents of net worth certificates for agricultural banks apparently have little understanding of the financial dynamics of an FDIC-assisted bank failure. While every bank failure involves at least some degree of pain for the people directly affected, the financial assistance rendered by the FDIC in connection with most failures is very substantial and has a positive effect on the failed bank's community.

Let me explain, using a typical $50 million bank failure to illustrate. Normally, the bank closing takes place at the end of the day on Friday. The FDIC buys all of the failed bank's troubled loans at book value for cash. The amount in a bank of this size would be in the range of $20 million or more. The "clean" failed bank is then sold to a healthy bank through a competitive bidding process, and the new bank opens at normal hours on Monday morning.

In this typical case, no depositor loses a penny of principal or interest or suffers the slightest delay or inconvenience in obtaining funds. Just as important, the community has been given a new, healthy bank. It is a well-capitalized, well-managed bank with no problem loans and $20 million or more in FDIC cash that it can put to work in the community. Last year alone, the FDIC injected over $1½ billion into small communities throughout the country in this fashion.

A net worth program would have no positive effect on either the troubled bank or its community. I.O.U.'s would be exchanged between the bank and the FDIC which would augment the bank's capital on paper; the bank would receive no financial help. The community would be left with a crippled institution with depleted real capital and a large portfolio of bad loans to try to collect. More often than not, the management of the bank would be weak and ineffective. The bank would not be in a position to extend new loans and, in fact, would likely be forced by its financial circumstances to be more aggressive than the FDIC in trying to collect on the problem credits in its portfolio.

The only circumstances in which a net worth certificate program for agricultural banks would make any sense at all, in our judgment, would be if there were so many bank failures occurring that the FDIC could not arrange orderly takeovers by sound banks. Then it would be appropriate to use net worth assistance on a temporary basis until takeovers could be accomplished. Under the Garn-St Germain Act the FDIC has the necessary authority to implement such a program, and we have contingency plans to do so should the need ever arise.

Some people try to justify a net worth certificate program for agricultural banks on the ground that thrifts were given such a program in 1982. However, there are significant differences between the thrift situation and agricultural banks that make the thrift program less objectionable.

1. The problem is different. The thrift problem resulted primarily from loans of fundamentally sound credit quality whose value was significantly diminished by a sharp increase in interest rates. For the most part, there was little question

about the borrowers' continued ability to repay, but the loans carried low, fixed interest rates when the lending institutions needed to pay much higher rates for their funds. Thus, thrift operating losses resulted not from an inability to collect principal but from an excess of day-to-day operating expenses over day-to-day income. As the principal of these low-yielding loans is repaid, the institutions are able to reinvest the funds at higher yields. This, combined with the general reduction in interest rates that has occurred, makes it reasonable to expect that many lenders with low-yielding real estate loans will return to profitability. Net worth certificates authorized by the 1982 Garn-St Germain law allow those institutions to operate until that happens.

For commercial banks strapped with problem agricultural credits, however, there is no reasonable expectation that the mere passage of time will correct the situation. While loans for current operating costs might be able to be repaid from crop proceeds, many farmers would still have insufficient cash flow to reduce the large overhang of debt accumulated for land and equipment purchases. Equipment continues to depreciate, and it is unlikely -- without significant new inflation -- that the value of the more expensive land will return to a level sufficient to cover acquisition loans.

2. Shareholder bailout is inappropriate and counterproductive. Unlike the thrifts assisted under the current net worth certificate program, agricultural banks are stockholder owned, and a net worth certificate program would represent an unwarranted and undesirable lifeline for stock investors who are and ought to be at risk. If a bank's capital were depleted by loan losses and the bank received FDIC net worth assistance, the result would be to allow an insolvent bank to remain in operation instead of forcing the shareholders to invest new capital. Moreover, our supervisory efforts to help rehabilitate troubled banks would be seriously impeded. Typically, among the corrective measures a troubled bank is called upon by its supervisor to take is to raise additional capital. With net worth assistance available from the FDIC, bank shareholders would have a strong incentive to resist such needed corrective action.

3. Cost. The present net worth certificate law for thrifts provides that assistance cannot be given if it would be more costly than liquidating the bank. Because the thrifts' problem is not one of credit quality, as their low-yielding loans mature and the funds are redeployed at market rates, the institutions' prospects improve, and the FDIC's exposure declines correspondingly. This assumes, of course, that management avoids imprudent behavior, which we closely monitor. In contrast, keeping an insolvent commercial bank open provides the occasion for management to make additional poor quality

loans or to mismanage existing problem credits, further diminishing the overall quality in the loan portfolio. That means that when the bank eventually failed, the potential exposure to depositors, creditors and the FDIC would be greater. In other words, net worth assistance would delay failure, not prevent it, and during the delay losses would almost certainly increase the costs to the FDIC and others. Moreover, it would be highly undesirable for federal assistance to be used to preserve existing bank management who, whether through misfeasance or simple ineptness, were responsible for a bank's plight.

With the comparatively large number of problem banks, the FDIC is uniquely sensitive to the problems in the agricultural sector as they affect our nation's banking system. For the reasons I have outlined, however, the FDIC strongly opposes a net worth certificate program for agricultural banks. It would do nothing to solve the problems of agricultural banks, would escalate FDIC losses, and would weaken the banking industry; perhaps most importantly, it would deprive our agricultural communities of the services offered by strong, well-managed banks with substantial amounts of loanable funds supplied by the FDIC.

Mr. Chairman, while there are problems among agricultural banks, there is clearly no crisis. Agricultural banks for the most part are strongly capitalized, profitable and well-managed institutions. Out of 4,100 agricultural banks, based on year-end '84 data, only 52 had capital-to-assets ratios of less than 5% and only 14 had less than 3%; only a comparative handful are in danger of failing. If a crisis should develop, the FDIC, thanks to the Garn-St Germain Act, has the tools it needs to respond. We will not hesitate to use those tools if conditions should ever warrant.

In sum, the proposed legislation is not needed and, if enacted, could only have a deleterious effect.

* * * * *

Senator GORTON. Thank you very, very much.

Mr. Naylor, your statement of course will also be included in the record as if read, but you may proceed.

STATEMENT OF FRANK W. NAYLOR, JR., UNDER SECRETARY OF AGRICULTURE FOR SMALL COMMUNITY AND RURAL DEVELOPMENT

Mr. NAYLOR. Thank you, Mr. Chairman. With your permission then, I would only make a few opening comments and then also take your questions.

Early this year, the President requested that Secretary Block chair a coordinating group composed of the FDIC, the Department of Treasury, the Office of OCC, and representation of the Federal Reserve, in an effort to coordinate and to provide appropriate assistance and review with regard to agricultural lending activities in commercial banks and the Cooperative Farm Credit System which is represented on this group by its governor.

SUPPORT FOR OPERATING REQUIREMENTS

It is our view within the Department that that group has worked very well together in providing common forbearance policies. In the process, we have developed a procedure in which we work with the FDIC to put teams from the Farmers Home Administration into communities where failed bank situations have occurred to provide support and assistance to producers who have been unable to get their immediate operating credit requirements as a result of that situation. That has worked quite well.

The problem that we face in agricultural credit today is not going to be solved today or tomorrow and we are going to continue to see some stress in the lending and financial community in agriculture for perhaps another year to 2 years' time.

I believe that we have worked effectively with the regulatory group and that they have been understanding and willing to work with us effectively in dealing with specific problems that exist in those areas. I commend the banking industry itself, both the Cooperative Farm Credit System and the commercial lenders, who have continued to work with us to supply necessary operating credit so that operators can indeed get into the fields this year, which we believe we have successfully done.

Based on current planting intentions and current estimates, it appears that most of our operators have indeed received their operating credit for this year. The planting intentions substantially indicate that we will have at or near record levels of planting and crop activity in the year ahead.

This does not minimize some of the longer term problems that are still before us, including real estate issues, which are primarily focused within the Cooperative Farm Credit System and its Federal land bank operations. This issue is a very complex and separate subject which we would be pleased to review with the committee or staff members at your convenience but I will not take the time to go into today.

We believe that we have successfully met the short-term needs this year but the complex problems that are before us are going to

require better solutions and, frankly, Mr. Chairman, the solution is not more and bigger Federal credit programs. The solution is better farm policy in the form of new farm legislation and, quite frankly, Mr. Chairman, the biggest gift that the U.S. Senate could give to the American farmer in this situation is the passage of the budget resolution before the Senate at this very moment because of the impact it would have on our competitiveness in the international marketplace and on the interest rates that our producers are having to pay from their operating standpoint. If there were anything that we could offer to you today as a solution to the problem I think it would well be the passage of the budget resolution and its successful implementation.

[The complete prepared statement follows:]

Testimony of
FRANK W. NAYLOR JR.
UNDER SECRETARY OF AGRICULTURE
FOR
SMALL COMMUNITY AND RURAL DEVELOPMENT
Before the
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
April 26, 1985

I appreciate the opportunity to be with you today to discuss the activities of the Farmers Home Administration in light of today's farm credit situation.

Currently, about 264,000 farmers and ranchers hold loans of one type or another with us. Farm operating, farm ownership and emergency loans make up by far a majority of our farm loan portfolio, which now totals about $25.5 billion.

Farmers Home provides about 12 percent of the nation's agricultural credit. Our borrowers have been undergoing the same stresses that other farmers have been experiencing in a time of low profitability. In fact, our borrowers were among the first to face those problems because of their relatively higher vulnerability to financial pressures.

In recognition of those economic forces beyond the control of the Farmers Home borrowers, Secretary Block took the first steps more than three years ago in adopting a policy based on forbearance, patience and understanding.

47-312 O—85——3

He said that we would stay with those farm borrowers who had tried, in good faith, to keep up payments but could not because of circumstances beyond their control, had taken care of security property, had followed sound management practices, and had prospects of repaying a new operating loan out of the current year's production.

In some cases, this meant carrying existing loans in a delinquent status while allowing the farmer additional time to restore a degree of financial stability to the operation.

At the same time that Secretary Block issued these policy directives, he undertook to strengthen the relationship between the Government and the commercial lenders in the private markets. Informal discussions with the major banking organizations and the Farm Credit System developed into a strong, working relationship that produced immediate and measurable results.

For example, the practice of subordinating Farmers Home's lien position on a loan by a commercial lender greatly expands the lending "reach" of both. From a yearly average of about 5,000, the number of subordinations jumped to 30,000 in fiscal year 1982 and has gone beyond 30,000 in each fiscal year since.

Mr. Chairman, those farmers simply would not have been able to continue in business without that extra assistance.

Another specific result of that cooperative working relationship with the commercial lenders was the development of the approved lender program during 1983 and early 1984. Under that plan, commercial lenders can be certified, in advance, as qualified to handle Farmers Home guaranteed loans, greatly simplifying and speeding up the processing of those loans.

Just last month, we made some adjustments in the program to make it possible for most of the institutions of the Farm Credit System and many more commercial banks to participate.

Those are some of the early and continuing efforts of this Administration to address the credit needs of that 12 percent of the nation's farmers served by the Farmers Home Administration.

Now let me briefly review the more recent steps taken as the farm credit situation worsened as a result of a world-wide recession and declining land values following a successful attempt to reduce the rate of inflation.

Last September, President Reagan announced a series of initiatives to help farmers undergoing financial stress, both those with loans from Farmers Home and those doing business with private lenders.

If a positive cash flow could be achieved:

o Farmers Home borrowers could have either 25 percent or $200,000 (whichever is less) of their FmHA debt set aside for five years without interest.

o Farmers Home would guarantee a new note for other borrowers whose loans were classified as problem loans if their lenders agreed to write off a minimum of 10 percent of their debt.

Farm financial and management counseling services would be made available, through contracts, at the county office level.

Based upon actual experience and recommendations from the banking community, some adjustments were made in the original program. The reduction of the non-FmHA borrower's debt can now be achieved through a lowering of the interest rate or a write-down of the existing debt (principal and accrued interest), or a combination of both, at the option of the borrower and lender. A 10-percent contingency originally included in the cash flow requirement for the guaranteed loans has been eliminated.

And, as I just mentioned, the approved lender program was adjusted to allow, and encourage, the participation of hundreds of additional lenders.

Where do we stand today? Since this fiscal year began Oct. 1:

o More than 9,200 Farmers Home borrowers have had part of their debt set aside for five years.

o More than 48,600 others have had their loans rescheduled or reamortized, deferred or subordinated to other lenders.

o One hundred and twenty nine new guarantees for $19.5 million have been approved after restructuring. Regular guarantees outside the restructuring program total more than 2,500 for operating and ownership loans.

o Almost 800 contracts for counseling services have been approved.

o Hiring of temporary employees and agreements with other USDA agencies have resulted in more than 2,000 additional personnel becoming available to help in loan processing.

o The creation of 20 five-person "farm credit crisis teams" permits us to send a team into a community immediately after the Federal Deposit Insurance Corporation notifies us of a bank failure. Team leaders are authorized to issue notices of intent to guarantee 1985 crop loans for eligible farmers whose loans were held by the failed bank. Twelve teams have been dispatched, so far, to seven states.

o More than $3.6 billion in all types of farm loans have been obligated by the Farmers Home Administration thus far in FY 1985.

Mr. Chairman, the direct contribution of the Federal Government to the current credit needs of our farmers has been substantial. I believe we are on the right course. Secretary Block has assured all of us that adequate financial resources will be available to meet the need.

We intend to continue our efforts to be sound managers of the responsibilities assigned to us by the President in our role to help ensure the continuing economic well-being of the nation.

Thank you.

Senator GORTON. Thank you, Mr. Naylor. Unfortunately, you are preaching to the choir.

Mr. NAYLOR. Thank you, Mr. Chairman.

Senator GORTON. Mrs. Egginton, in many cases bank problems appear to be due to heavy concentration of loans in a single industry and of course that's in essence what we're here discussing today.

Do bank examiners apply any standards for portfolio diversification during the course of their examination?

Mrs. EGGINTON. Yes, they do. My colleague, Dave Meadows, who is an examiner by training and background, is going to be addressing you later on this morning, and he's probably better able to address that in detail. But the short answer is yes.

Senator GORTON. Is the FDIC satisfied with the size of its examination staff and with its ability to attract and retain skilled examiners?

Mrs. EGGINTON. We are currently understaffed and are hiring throughout the country to beef up our examination staff. We believe it's a problem, but we believe we are addressing it and taking the steps necessary to solve it.

Senator GORTON. Suppose the collateral on a loan has fallen in value dramatically, as is obviously the case in many of these instances, but the debtor continues to make timely payments on the loan nevertheless.

How does an examiner evaluate that loan? Is it considered to be a problem loan?

Mrs. EGGINTON. Again, I have to defer to my colleague, Mr. Meadows, to explain how an examiner would deal with such a loan. But a current loan is by and large not a problem.

Senator GORTON. Mr. Naylor, a few weeks ago when Congress debated farm credit assistance we were told that the problem was immediate, that spring planting loans were being made at that time and action delayed was as bad as no action at all. Now we are 1 month after that debate.

Has the situation changed? Have the farmers put off financing or have they in some way or another gotten the loans which they require?

Mr. NAYLOR. Mr. Chairman, by and large, the short-term operating credit needs have been met in American agriculture either through the commercial banking system, the Cooperative Farm Credit System, or the Farmers Home Administration programs.

OVER $2.5 BILLION COMMITTED TO SHORT-TERM NEEDS

As of today, we have committed over $2.5 billion of direct short-term operating funds, which is a record amount, and already have set aside an additional $900 million over the original authorization of Congress for the purpose of meeting operating credit this year.

In addition, we are seeing a late but a surge of activity by the commercial banks and the Production Credit Associations in this country for our guaranteed lending. We have now lent over $355 million of the $650 million originally authorized. I would expect we will use all of it and if it requires additional transfers we will provide it.

About 10 percent of that has gone into the Debt Assistance Program for the most troubled cases which banks have elected to use that program in lieu of either direct loans from Farmers Home Administration or other alternatives which are available to them.

Senator GORTON. I'm going to terminate your testimony now because we have two more panels and some real difficulties with the chairman's time. But I do thank you for your patience and your help and will request that you answer additional questions in writing from the Chair and from other members of the committee.

[Response to written questions of Senators Gorton and Sasser follow:]

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C.

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

1985 MAY 20 AM 12:24

May 17, 1985

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON

1. Does the FDIC have summary measures of how far the collateral value on agricultural loans has fallen? Under what circumstances do bank examiners require that this be reflected in the bank's accounts?

Question 1. The FDIC has no summary measures on changes in collateral values supporting agricultural loans. It has been our experience that changes, especially in land values, have varied from state to state and among locales within a state. The degree and direction of change in a land's value depends largely on how inflated the past price level was in relation to the land's production capacity and net farm income prospects - the more disparate this relationship, the greater the depreciation potential.

The diversity of changes in land values is exhibited in a recent United States Department of Agriculture report which shows the change in average value of farmland per acre from 1981 to 1984 varying from a 32 percent increase in Texas to a 28 percent decrease in Iowa. This study reflects greater depreciation experience by the midwestern states, where land values had been the most inflated. However, within these states we have noticed substantial differences in value changes depending on the location.

When analyzing loans, our examiners assess the extent of support offered by collateral and needed to justify the loan amount. If there is insufficient collateral margin and the borrower's repayment ability, along with other support, is lacking, the examiner may classify the loan substandard, doubtful or loss according to the degree of risk determined to be present.

2. Suppose the collateral on a loan has fallen in value dramatically, but the debtor continues to make timely payments on the loan. How would the examiner evaluate such a loan? Would it be considered a problem loan?

Question 2. Our examiners' classification of loans is based essentially on the prospects for timely repayment. If, in an examiner's judgment, a borrower has exhibited satisfactory capacity and willingness to repay a loan in a timely manner, yet supporting collateral value has deteriorated below providing sufficient margin, the loan may not warrant classification or as severe a classification.

3. How does an examiner evaluate the degree to which a bank's portfolio is adequately diversified? We have heard of banks whose portfolios are 90% local agricultural loans. Does an examiner consider this adequate diversification? Should we tighten up on diversification standards?

Question 3. Adequate risk diversification within the asset structure is a basic tenet of sound banking. Examiner assessment of risk diversification, however, depends on reason and judgment. For example, if the loan distribution of a bank is heavily centered in one general class of borrower and this condition is inherent in the economy and character of the bank's trade area, such as farming, it would be inappropriate for an examiner to report these loans as constituting a concentration of credit and levy criticism. However, a loan portfolio centered in one general class of borrower, because of its vulnerability to economic changes peculiar to that class of borrower, should be maintained on a higher credit level than one with acceptable diversification. If this higher credit level is not maintained, examiner criticism is both appropriate and expected.

RESPONSE TO SENATOR SASSER'S COMMENTS ON PROPOSALS FOR AGRICULTURAL CREDIT

In addition, Senator Sasser has asked that you comment on his proposals for agricultural credit which are explained in the enclosure entitled "Farm Credit Relief Act of 1985".

The FDIC is well aware of the current problems being experienced by farmers and the resulting effects on banks serving agricultural areas. However, we do not believe these banks are facing a crisis. Our most recent figures indicate that problem agricultural banks represent about 7 1/2 percent of all agricultural banks. This compares with a 6 1/2 percent relationship of all problem banks to all banks in the country. There is clearly a disparity, but it does not indicate that agricultural banks are in materially worse condition than the banking industry as a whole. The vast majority of agricultural banks, nearly 93 percent, are not considered problem institutions.

There has been an increased number of agricultural bank failures over the past three years. However, as noted in our testimony, a depressed agricultural economy perhaps accelerated the failures, but, the primary cause in most instances has been mismanagement coupled in some cases with insider abuse.

The discussion in the proposal indicates that problem agricultural banks represent a threat to the FDIC insurance fund. Total assets of agricultural banks comprise only about 6 percent of all domestic bank assets, and again, just around 7 1/2 percent of agricultural banks are considered problems. The resources of the FDIC are more than adequate to handle the volume of farm-related bank failures without threatening its solvency or its ability to maintain confidence in the banking system.

Accounting related techniques suggested in the proposal appear to be patterned after concessions given the thrift industry by the Federal Home Loan Bank Board. The FDIC does not consider this approach as valid for banks, nor are we convinced that it has been effective in correcting the underlying problems of the thrift industry. About 27 percent of the nation's banks are defined as agricultural banks, and as noted, their condition as a group remains relatively sound. The approach of allowing special accounting rules and not timely recognizing and handling problem loans results in a misrepresentation of the condition of a bank and, thus, is unacceptable to the FDIC. It does not change reality but encourages liberal banking practices which lead to safety and soundness problems.

Of note is the fact that the proposal addresses only banks in the outline of its relief measures. Less than one third of farm credit is provided directly by commercial banks. The Cooperative Farm Credit System is the largest

institutional lender with over 40 percent of farm credit. Also, noninstitutional lenders provide a significant amount of agricultural credit. Any solution to the farm credit problem must attempt to include all major sources of farm loans. In conclusion we are opposed to the proposal as presented.

I trust this response satisfactorily answers the questions set forth in your letter, and we appreciate the opportunity to comment on Senator Sasser's proposal.

Sincerely,

Robert V. Shumway
Director

Mrs. EGGINTON. Mr. Chairman, may I just respond to a question you asked Governor Partee?

Senator GORTON. Certainly.

Mrs. EGGINTON. Of the 79 banks that failed in 1984, all but 5 were handled in such a way that the failed bank was taken over with FDIC assistance.

Senator GORTON. Has that continued to be true in 1985 with respect to the testimony of Senators Grassley and Exon?

Mrs. EGGINTON. Yes. The proportion has changed slightly. Of the 27 banks that have failed to date in 1985, all but 5 were handled in that fashion. And as I noted in my statement, that resulted last year in $1.25 billion being made available in communities where banks have failed.

Senator GORTON. But I assume that doesn't imply that all of them were kept open in the kind of small towns to which Senator Exon referred in his testimony?

Mrs. EGGINTON. No; indeed, they were closed. But the effect as far as depositors and borrowers at the bank is concerned is the same as if the bank had not closed.

Senator GORTON. So it simply has to do with the location of an office or of a bank then?

Mrs. EGGINTON. It's a legal proceeding. Typically when a bank fails and the FDIC is appointed receiver, it's reopened within a day or two under new ownership. So the effect on the community is the same as if the bank had never actually been closed. It doesn't close its doors literally. It's a charter revocation.

Senator GORTON. OK. Thank you both very much.

We would now like to hear from Mr. Gerhart and Mr. Tubbs. For the purpose of the rest of the witnesses, one of the other members of the subcommittee was to succeed the chairman at approximately 11 o'clock and will be unable to come. I suspect we are not likely to get to panel 4 before that time. I will be gone for roughly 30 minutes. If we can secure another member of the committee, we will go straight on. Otherwise, we will recess, but I will return to hear the testimony of those of you on the last panel.

Mr. Gerhart and Mr. Tubbs, as was the case with the previous witnesses, your written statements will be included in the record as if read in full. If you will summarize your testimony, we will have

a chance to question you and to complete your appearance before the subcommittee.

STATEMENT OF H.L. "BUD" GERHART, CHAIRMAN, AGRICULTURE COMMITTEE, INDEPENDENT BANKERS ASSOCIATION OF AMERICA; PRESIDENT, FIRST NATIONAL BANK, NEWMAN GROVE, NE

Mr. GERHART. Thank you.

Mr. Chairman and members of the committee, my name is Bud Gerhart and I am chairman of the agriculture rural committee of the Independent Bankers of America. I am also president of the First National Bank in Newman Grove. About 90 percent of the loans in my bank are agricultural loans.

The Independent Bankers Association of America is a national trade association of community banks representing about 7,800 small- and medium-sized banks throughout the States. About one-third of our membership might be described as agricultural banks.

ONE-THIRD OF FARMERS EXPERIENCING DIFFICULTY

USDA reported that about one-third of the family-sized commercial farmers are facing some degree of financial difficulty. About 43,000 of them who owe a total of $19.7 billion debt are technically insolvent.

Another 50,000 owing about $23.5 billion have debts equaling at least 70 percent of their total assets; and another group, 136,000 of them, have debts of $54.9 billion which amounts to about 40 percent of their assets, a level generally considered to raise a red flag in farm lending.

Together, these farmers owe about $98 billion of the $212 billion of total farm debt, which is about 46 percent of the total.

The Guaranteed Loan Program of the USDA has not been adequate in dealing with all of the troubled farm debt situation. In recent weeks, attention has focused on the credit needed by farmers to finance their 1985 production. However, it's important to recognize that in order to extend new financing for 1985 the producer's lender must somehow find his total debt load, including his existing debt, to be manageable. And this backlog is a problem.

The Farmers Home Administration has increased the funding available for direct operating loans this year, but these FmHA loans are made largely to cover the 1985 production expenses and haven't affected the borrowers' backlog of existing debt.

The severely tight financial situation in agriculture has been building almost steadily since 1981 and by the middle of this year the capacity of the commercial and cooperative farm lenders to absorb or stretch out potential losses is being rapidly exhausted.

The sharp increase in agricultural bank failures during the past 9 months—10 of them in Nebraska as Senator Exon pointed out—documents how more and more agricultural banks are being pushed below their bottom line with regard to required capital levels. Thus far in 1985, 16 of the 27 banks which have failed were agricultural banks.

The capacity of agricultural lenders themselves to absorb potential losses from farm debt is rapidly expiring and simple equity would seem to require that some assistance be provided.

Last year when the FDIC and the Fed came to the rescue of Continental Illinois, many people said that it was time to do something about the double standard in banking. They reasoned that, while rural banks were being closed left and right, the Government had created a new class of banks—those too big to fail.

Governor Partee mentioned the bill S. 795 pending before your committee, which would broaden the Net Worth Certificate Program to include qualifying agricultural banks with agricultural loans constituting at least 20 percent of the bank's total loan portfolio.

Giving agricultural banks access to the Net Worth Program would be a step in the right direction. It would recognize that just as Continental was deemed essential to the banking system, many rural banks are vitally essential to the economic health of their own communities. Similarly, extending the program to agricultural banks would help them maintain their capital the same way as many thrifts have been helped. One of the strongest justifications for the original Net Worth Program was that the thrifts were being harmed simply because they did what they were expected to do, namely, provide fixed rate home mortgages. When economic changes beyond their control began threatening their existence, Congress stepped in.

This is exactly the situation many agricultural banks find themselves in. They exist to serve the farming communities. Economic forces beyond their control are forcing them to rapidly draw down their capital it took years to accumulate. It is only fair that the Government do for agricultural banks what it has already done for the thrifts.

The extension of the Net Worth Program to agricultural banks should not add to the Government deficit.

The Net Worth Program contains very demanding qualifications for recipients. To qualify, an institution must, in addition to meeting the statutory requirements, file a comprehensive business plan that satisfies the agency and agree to conditions involving employment contracts, severance plans, and so forth. We are convinced that the inclusion of agricultural banks in a 3-year extension of the Net Worth Program is the best step which this committee can take at this time to assist in coping with the very severe credit problems facing agriculture. I would urge you to take early action approving this measure.

I have one additional comment about the FDIC's comments that when they move into a community and take over a bank, they keep the bank going or turn it over to some other banking agency or bank. The FDIC is not a lender. They are a liquidator, and although they may turn the good loans over to some other bank, the intermediate type loans or the marginal loans as I call them, sometimes are out looking for a home and can't find one. And so having the FDIC take over these banks is not a solution to many of the farmers that have lost their source of credit.

Senator GORTON. Mr. Gerhart, before we go on, are you the author of Senator Exon's bill?

Mr. GERHART. No, I am not. There are a lot of bankers in Nebraska that probably could qualify for that. [Laughter.]

[The complete prepared statement follows:]

STATEMENT OF BUD GERHART, CHAIRMAN, AGRICULTURE-RURAL COMMITTEE, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman and Members of the Committee, my name is Bud Gerhart and I am the Chairman of the Agriculture-Rural Committee of the Independent Bankers Association of America. I am also President of the First National Bank in Newman Grove, Nebraska.

IBAA is the national trade association of community banks, representing some 7,800 small and medium-sized banks throughout the United States. About one-third of our membership might be described as agricultural banks, in that loans to agricultural producers comprise a substantial portion of those banks' loan portfolios.

The credit problems facing agriculture today are quite severe. A publication released last month by USDA reported that about one-third of the 679,000 family-sized commercial farmers, or about 229,000 of those farm producers, are facing some degree of financial difficulty. Of those 229,000, the USDA states that:

- About 43,000 farmers, who owe a total of $19.7 billion of farm debt, are "technically insolvent;" their debt exceeds their total assets;

- About 50,000 farmers, owing $23.5 billion of debt, have "extreme financial problems." Their debt equals at least 70 percent of their total assets; and

- Another 136,000 farmers, who owe $54.9 billion of debt, have "serious financial problems;" their debt exceeds 40 percent of their assets.

Together, those 229,000 family-sized commercial farmers facing financial difficulty, according to the USDA, owe $98.2 billion of the $212 billion of total farm debt outstanding on January 1, 1985--or 46.3 percent of total farm debt.

The guaranteed loan programs of the USDA have not been adequate in dealing with the troubled farm debt situation. As of April 15, $373.8 million of regular Farmers Home Administration farm loan guarantees have been approved involving 2,508 borrowers. Only $19.5 million of additional FmHA guarantees to 129 borrowers was made under the Administration's Debt Adjustment Program.

In recent weeks, attention has focused on the credit needed by farmers to finance their 1985 production. This is a proper focus, because the producer's ability to finance his 1985 operations determines whether or not he remains in business. However, it is important to recognize that in order to extend new financing for 1985, the producer's lender must somehow find his total debtload--including existing debt, to be manageable. And this backlog of existing debt presents the basic problem, in most instances.

The FmHA has increased the funding available for direct operating loans by some $900 million, and total available funding for the current year is now $2.82 billion. However, to the extent that such loans have gone to borrowers from commercial lenders, the FmHA loans have been made largely to cover 1985 production expenses only and have not affected the borrowers' backlog of existing debt.

Today's severely-tight financial situation in agriculture has been building almost steadily since 1981. Until the latter half of 1984, the cushion which was built into the agricultural credit system in the form of collateralization which often exceeded the face value of farm loans, relatively strong capital levels of lending institutions, and rather high liquid asset levels among farmers, enabled the system largely to absorb or stretch out the mounting incidences of losses. However, by mid-1985 this capacity of the commercial and cooperative farm lenders to absorb and/or stretch out potential losses was being rapidly exhausted.

The sharp increase in agricultural bank failures during the past nine months documents how more and more agricultural banks are being pushed below their bottom line with regard to required capital levels. Six of the 43 banks which failed in 1983 were agricultural banks. In 1984, 26 of the 79 failed banks were agricultural banks, and 22 of the 26 agricultural

bank failures occurred during the last half of 1984. Thus far in 1985, as of April 24, sixteen of the 27 banks which have failed were agricultural banks.

As indicated, the capacity of agricultural lenders themselves to absorb potential losses from troubled farm debt is rapidly expiring, and simple equity would seem to require that some assistance be provided. Last year, when the FDIC came to the rescue of Continental Illinois, many people said that it was time to do something about the double standard in banking. They reasoned that, while rural banks were being closed left and right, the government had created a new class of banks--those too big to be permitted to fail. However, basically nothing has been done to even the score.

As a first step, we recommend that Congress broaden the Net Worth Certificate Program under the Garn-St Germain Act of 1982, expressly to include agricultural banks, and that the broadened program--for both thrifts committed to housing and banks committed to agricultural lending--be extended for an additional three years.

The bill S. 795, pending before your Committee, would broaden the Net Worth Certificate Program to include qualifying agricultural banks with farm loans constituting at least 20 percent of the bank's total loan portfolio. Eligibility for

capital certificate assistance would trigger if a bank's capital deteriorated to six percent of assets--or at a higher level if a higher level of capital was required by the bank regulators.

Giving agricultural banks access to the Net Worth program would be a step in the right direction. It would recognize that, just as Continental was deemed "essential" to the banking system, many rural banks are essential to the economic health of their communities.

Similarly, extending the program to agricultural banks would help them maintain their capital the same way that many thrifts have been helped. One of the strongest justifications for the original Net Worth program was that the thrifts were being harmed simply because they did what they were expected to do, namely, provide fixed-rate home mortgages. When economic changes beyond their control began threatening their existence, Congress stepped in.

This is exactly the situation many agricultural banks find themselves in. They exist to serve the farming community. Economic forces beyond their control are forcing them to rapidly draw down the capital it took them years to accumulate. It is only fair that the government do for agricultural banks what it has already done for the thrifts.

The extension of the Net Worth program to agricultural banks should not add to the government deficit. Indeed, when the Congressional Budget Office prepared the cost estimate for this Committee's Net Worth bill in 1982 it said that: "The availability of the guarantee authority is expected to reduce the need for the various forms of cash assistance provided by the government's thrift insurance agencies." CBO's estimate for the Senate's capital assistance program also projected a cost saving for the government.

The Net Worth program contains very demanding qualifications for recipients. To qualify for the FDIC's program, an institution must, in addition to meeting the statutory requirements, file a comprehensive business plan that satisfies the agency and agree to several conditions. Those conditions include among other things that employment contracts with senior management must be for less than one year; severance plans may not provide payments for longer than six months; the bank must file quarterly statements of income and condition; and, the bank must have annual audits by a public accountant.

For the reasons indicated, we are convinced that the inclusion of agricultural banks in a 3-year extension of the Net Worth program is the best step which this Committee can take at this time to assist in coping with the very severe credit problems facing agriculture. I would urge you to take early action approving this measure.

This concludes my prepared statement, and I would be pleased to respond to any questions.

Senator GORTON. Thank your, Mr. Gerhart.
Mr. Tubbs.

STATEMENT OF ALAN R. TUBBS, CHAIRMAN, AGRICULTURE BANKERS DIVISION EXECUTIVE COMMITTEE, AMERICAN BANKERS ASSOCIATION AND PRESIDENT, FIRST CENTRAL STATE BANK, DE WITT, IA

Mr. TUBBS. Thank you, Mr. Chairman. We appreciate you holding these hearings to give us a chance to testify on these issues important to agricultural banking.

I am Al Tubbs, president of First Central State Bank in De Witt, IA. First Central State Bank is a $35 million bank in a community of about 4,500 people, totally tied to agriculture.

I am representing the American Bankers Association [ABA], whose membership represents approximately 13,000 banks—95 percent of the banking industry. Our members range in size from the smallest to the largest, but approximately 85 percent of them have assets of less than $100 million, many of which are serving the agricultural community.

We don't need to reiterate all the sources of the problem. We know the historical situation—it is very well documented in a recent USDA publication on the current financial condition of farmers and their lenders.

To summarize some of the impact the troubled agricultural situation is having on lenders, there has been an increase in loan delinquencies and agricultural banks are making up a significantly larger percentage of failing banks.

It has been said that lack of diversification is the problem for farming communities, and, indeed, that is true, but it is very difficult in small rural communities to diversify very far beyond agriculture. We are also confined somewhat by the Community Reinvestment Act.

TROUBLED BANKS

This week, during a meeting with the Kansas Bankers Association, we the ABA learned that of 628 banks in the State of Kansas, 104 lost money in 1984—an alarming statistic and certainly different from our experience of the last 10 years. In Iowa, 25 percent of our 600 banks are on the troubled bank list, primarily due to the agricultural situation, and nationally, the total troubled bank list has increased from 183 in 1974 to over 800 today. Our concern about the problems in agricultural credit may not be termed crisis today by the FDIC, but, there is a tone right under the surface that says that we could have a major crisis, if conditions don't change, particularly for agricultural banks.

If it is not a problem in terms of dollars, I think when we are looking at the number of bank failures, we have to wonder about the level of confidence in the banking system. Based on the agricultural credit and farm debt situation, I see an impending, unavoidable, and serious problem for this year and the near future, as farmers hit the point of no return; their leverage situation begins to have a domino effect on asset values, eroding equities and eroding collateral values.

Statistics show that land values have declined by 28 percent in the State of Iowa, but in reality, in many cases it is over 50 percent. This dramatic drop has happened over just 3 or 4 short years.

Given this context, I would like to address a few issues. All of them are explained in the written testimony, so I won't cover all the details.

The first issue I would like to address is bank regulation, an issue that Senator Grassley has also mentioned. Over the last 3 years the ABA has worked with the bank regulators, holding meetings, trying to make sure that they are apprised of what is going on in the farm economy. Our findings from those meetings suggest that in the vast majority of cases, bank examiners are knowledgeable and informed about the agricultural credit situation. Their job is a tough job. It is an adversarial job. For the most part, our reports indicate that they are doing a good job.

Generally, we've received a favorable response from the surveys that we have compiled. We gathered responses from 794 banks. Eighty-eight percent indicated there were no major disparities between their list of problem borrowers and the list of the examiners.

Yet there are problems. I met with a banker from Missouri yesterday who indicated that he had a problem in particular with FDIC examinations. They returned to his bank 1 week after the examination and actually wanted to go out onto a farm. They were suggesting a sale out of trust, some writeoffs, and some action on the loan which the banker felt were out of the ordinary.

We have heard some reports of cases like this, but they are the exception, not the rule, and tend to be more in the area of Federal examinations than State. We just concluded a State examination last week. I found the examiners to be quite fair in their discussion and classification of the loans.

Banks are having difficulty maintaining capital as they use the Farmers Home Administration writeoff program or experience losses through agricultural lending. We intend to maintain this dialog with the regulators, and we are asking regulators to give the banks time to work through some of the most difficult cases which cannot be solved overnight. Throwing more assets through forced sales into an already depressed market can only exacerbate the problem.

As capital deteriorates in some agricultural banks, it is possible that we will need something along the lines of the Net Worth Certificate Program. Commercial banks do not qualify for the Net Worth Certificate Program at this time because of the requirement that banks have 20 percent of their loans in real estate. In order for more banks to qualify for or implement the program the 20-percent requirement would need to be changed. This concept is already part of the bill that has been introduced. However, ABA recommends other changes in the Net Worth Certificate Program which will eliminate the discrepancy between standards and regulations for the savings and loan industry and banks. The ABA recommends equity in capital, disclosure and the representation of the savings and loan industry to the public.

The recent bank holiday in Ohio was clearly not a bank crisis, it was a savings and loan crisis, and yet it was repeatedly reported as being a bank crisis. We are suggesting that when the Net Worth

Certificate Program is expanded or extended, that it stipulate the savings and loan industry increase their capital requirements over time up to the standard level of banks, if they are to be permitted to continue to use the word banks in their name. If this stipulation is not complied with, then we are, in effect, practicing public deception.

To the extent that the Congress determines that because of a lender's involvement in mortgage or agricultural lending sound capital requirements should be temporarily waived, we have no objection to qualifying agricultural banks for use of the Net Worth Certificate Program.

FARMERS HOME ADMINISTRATION

Let me discuss briefly the situation with Farmers Home Administration. We are working very closely with the FmHA on their programs. We agree with them on moving away from subsidized lending and toward guaranteed lending. This is the direction we should take to prevent a larger and larger percentage of farm lending from moving into the hands of Government control. And yet that's been the direction in the past. We are shifting more toward guaranteed programs and away from direct lending, but the change needs to come about very slowly. There are a large number of farmers who are tied to direct Farmers Home Administration loans, and to cut that credit support quickly would be a real problem.

We appreciate the opportunity to implement the interest rate write-down option of the Debt Adjustment Program and we are writing off income in the future rather than writing off capital all at once. The interest rate write-down option is a help, and the reason, I believe, it hasn't been used a great deal is because the seriousness of the farm situation is such that these loans are not only not bankable, they are poor enough that the Farmers Home Administration doesn't want to finance them either.

It is not automatic just to take a write-down and transfer it to the Farmers Home Administration for Federal loan guarantee. On another point, one agency that is not represented here this morning——

Senator GORTON. Make this your last subject matter, would you? So I can have a chance to ask questions of both of you.

Mr. TUBBS. OK. The Farm Credit System—an agency created by the Federal Government and a direct competitor and a major lender to the agricultural community and farmers. Because of their involvement in the rural financial community, they ought to be here. They are proposing an Agricultural Conservation Corporation [ACC] to buy agricultural assets to help provide a bottom to declining asset markets. We believe that that is something that might be worthwhile, and necessary in the future. However the question of funding this proposal remains.

I have a number of other issues that I could address, but basically, all of the issues that I have talked about have little impact on the Federal budget. The bottom line is we agree with Mr. Naylor that the budget and its impact on interest rates and the value of the dollar are the things that are really going to make the differ-

ence in the future. And if we don't see some adjustments in our ability to sell commodities overseas and in our ability to finance at lower interest rates, then the kind of a crisis that I was talking about earlier could become reality.

[The complete prepared statement follows:]

PREPARED STATEMENT OF ALAN TUBBS, CHAIRMAN OF THE AMERICAN BANKERS ASSOCIATION, AGRICULTURAL BANKERS DIVISION EXECUTIVE COMMITTEE

Mr. Chairman and Members of the Committee, thank you for holding this hearing and allowing our organization the opportunity to testify. I am Alan Tubbs, President, First Central State Bank, DeWitt, Iowa. I am representing the American Bankers Association and I am currently Chairman of the Executive Committee of the Agricultural Bankers Division of the ABA.

The combined assets of our nearly 13,000 member banks represent approximately 95% of the industry total. While our members range in size from the smallest to the largest banks, approximately 85% of them have assets of less than $100 million.

Mr. Chairman, I know that I do not need to extensively review for you the current agricultural problem. The effects are displayed daily on the front pages of the newspapers from coast to coast.

I recommend the recent report by the Department of Agriculture entitled "The Current Financial Condition of Farmers and Farm Lenders" to anyone interested in an economic analysis of the extent of the problem. A few key facts contained in that report illustrate the problem facing us:

- o There are over 4,000 agricultural banks in this country (for purposes of this report, an agricultural bank was defined as having under $500 million in assets and more than 25% of total loans in agriculture).
- o In late 1984 loan delinquencies at non-agricultural small banks declined by 6% and at agricultural banks loan delinquencies increased by 10%.
- o In 1983, only 6 of 44 bank failures were agricultural banks (14%). Through June of 1984 only 8 of 42 failures involved

agricultural banks (19%). From June 1984 to mid-December 1984, 15 of 32 bank failures were of agricultural banks (47%).

On April 23rd, 1985, at the American Bankers Association's Spring Leadership Conference, the Kansas Bankers Association announced that of 628 banks in Kansas, 104 lost money in 1984. In my own state of Iowa, we are experiencing one bank failure per month. The trouble bank list in Iowa is now approaching 25%.

Problem Banks

The number of problem banks reported by the three major bank regulators (Comptroller of Currency, State Banking Commissions, and the FDIC) have increased over the last decade. But the significant increase in the number of problem banks has occurred during the last three years as shown in Table 1.

TABLE I

Number of Problem Banks Reported by Major Regulators

1970	1974	1978	1982	1983	1984
252	183	342	369	642	800

U.S. Bank Failures

Agricultural banks, those banks with agricultural credits comprising 25% or more of total loans of the bank, represent about 28% of the total number of insured commercial banks. Until recently, these agricultural banks were underrepresented among failing banks. But from June to September 1984, 10 of 27 banks that failed were agricultural

banks. The number of bank failures closely parallels the rapidly increasing number of problem banks among agricultural banks since 1983 (as shown in Table II).

As the number of problem and failed banks continues to increase, the confidence of the nation's banking system is eroded. Not surprisingly, the bulk of troubled and failed banks have a high percentage of agricultural loans.

The F.D.I.C. now estimates that they will close an average of 2 banks per week — over 100 banks in 1985. This means that the number of bank failures in 1985 will be almost four times the average number of bank failures per year for the previous 20 years.

TABLE II

Number of U.S. Bank Failures

Averaged Five Year Increments, Then Selected Years

1961-65	1966-70	1971-75	1976-80	1981	1982	1983	1984
6.6	6.4	6.8	9.8	10.0	42.0	48.0	79.0

Based on the agricultural credit and farm debt situation, I see an impending and unavoidable crisis for this year and possibly beyond as these highly leveraged farmers hit a point of no return.

My concern as these farm borrowers approach insolvency, foreclosure, or partial liquidation, is that this forced re-allocation of assets will cause further erosion of the asset values and will create a downward spiral. The deflation of agricultural assets is one of the major dilemmas facing today's farmers and agricultural lenders. For example, land in Central Illinois that sold in 1981 for $4,000 an

acre is slow to find a buyer today at $2,500 per acre.

While statistics show declines in land values of only 28% in Iowa, the real percentage today is over 50%. This loss of equity for the producer and loss of collateral for the lender threatens the existence and structure of one-third of the nation's farms and many rural communities and lenders. (Please refer to Attachment I.)

The concluding paragraph of the USDA report, which I noted earlier, summarizes well the situation we are facing.

> "Bank failures are currently running at 10 times their average annual rate for the past three decades. Institutional lenders, depending on the proportions of their portfolios in farm loans, may not be able to absorb likely increases in the numbers and amounts of troubled farm loans over the next few years without severe problems, further increases in lender failures, and increases in the costs of credit to agricultural borrowers." ("The Current Financial Condition of Farmers and Farm Lenders", USDA, March 1985, page 28).

In the context of these difficult times for farmers and agricultural banks, consideration of provisions affecting credit in the 1985 Farm Bill, the role regulators -- both federal and state -- and the safety and soundness of all financial institutions are very important to the members of the ABA. I shall briefly address the following matters : 1) Bank regulators and 2) net worth certificates (both of which fall under the Banking Committee's jurisdiction); 3) Farmers Home Administration; 4) Farm Credit System; 5) Farm Credit Council's land asset proposal; 6) alternative minimum tax; 7) bankruptcy modification; 8) clear title resolutions (which fall under another Committee's jurisdiction, but are extremely important to the agricultural and community banking industry); and 9) food stamp distribution system.

Bank Regulators

Recently, members of the ABA Agricultural Bankers Division participated in a number of meetings with the federal bank regulators -- meetings aimed at focusing on the problems of agricultural banks.

Let me describe to you the findings of the ABA Agriculture Executive Committee regarding the regulator situation:

1. First of all, the banking industry is blessed by having knowledgeable and informed bank examiners. They generally know the problems of agriculture and they are sincerely interested in helping me find ways to continue my financial support to these farm borrowers. Their job, as bank examiners, is to evaluate the quality of a bank's assets. They do that job well. The regulatory authorities bring the banking industry a measure of excellence and public confidence that could be achieved in no other way.

2. The ABA Agricultural Bankers Division recently surveyed 794 agricultural bankers (Attachment II) throughout the nation to get an up-to-date projection of the current financial conditions, the relationships between agricultural bankers responding to the survey indicated that their bank examiners were knowledgeable of agricultural credit and understanding of the problems within the agricultural industry. In addition, 88% indicated that there were no major disparities between the bankers' agricultural problem loan list and the findings of the bank examiners. In short, these 794 agricultural bankers generally felt that the efforts of the

bank examiners are helpful and that the credit analysis of the bank examiners are appropriate. I interpret this as a vote of confidence and appreciation from the agricultural bankers to the bank regulators.

3. Yet, we do have some serious concerns with aspects of the regulatory process. Many rural bankers complain that the bank examiners are being excessively critical or too aggressive in their analysis of the agricultural assets of the bank. Bank examiners are human. If the rural bank has a problem with a bank examiner, it's probably a situation typified by an overaggressive examiner and/or a banker who is slow to recognize the increasing risk in his bank's agricultural loan portfolio.

   Another problem is the capital requirements of rural banks. Building capital strength is the function of bank earnings. Yet, it's unrealistic to expect a community bank to grow and prosper in an agricultural economic environment that is unprofitable and losing its asset base. Thus the country bankers seek innovative ways of maintaining their present capital positions — such as, interest rate write-downs as compared to the principal write-down for emergency debt restructuring -- an alternative of the Debt Adjustment Program.

The problems in agriculture and the problems in agricultural banks are not caused by the examiners. Special times call for special efforts, more understanding, and closer examination.

Having said that, we would suggest two areas in which the

supervisory activities as they relate to agricultural banking could be improved.

As I stated earlier, in attempting to suggest methods of easing the impact of current agricultural problems on banks with concentrations of agricultural loans, our Association has, for the past three years, conducted regular meetings with the chief supervisory personnel of the federal banking agencies. The focus of these meetings has been on the need for understanding on the part of bank examiners when examining agricultural banks and agricultural borrowers. Although our Association would not suggest and could not support any generalized moratorium on bank closings, we do believe that, given time, many banks will be able to manage their own way out of their current difficulties.

Net Worth Certificates

Two important sections of the Garn-St Germain Depository Institutions Act expiring October, 1985 are the provisions of the law facilitating interstate mergers between failed financial institutions and the authorization of net worth capital certificates for troubled financial insitutions. Both of these provisions may become increasingly relevant to banks affected by the economic problems of the agricultural sector.

The net worth capital certificate has been widely used by the thrift industry, particularly the mutual savings banks. While commercial banks have been eligible for the capital certificate program, two statutory restrictions have made it virtually unused by banks. The restrictions thwarting bank use are the requirement for having 20% of an institution's assets in residential mortgages and the

requirement that a bank's capital be below 3% and that the institution experienced earnings losses for the most recent two successive quarters.

Given the extensive use of the net worth capital certificate program by savings and loans and mutual savings banks, ABA recognizes the strong appeal to the Congress to extend the net worth capital assistance program as provided in H.R. 683 and H.R. 913. Congress, in enacting the capital certificate program, wisely provided for a three year sunset provision in order to evaluate the need for continuing the program and making any mid-course corrections.

ABA recommends Congress consider several changes in the overall net worth capital assistance program. The unfortunate situation that has developed with state-insured savings and loans in the state of Ohio shows that the public perception of confidence in the thrift industry is intricately linked to confidence in our commercial banks. Many press reports on the closing of these savings and loan institutions indicated that it was a "bank holiday" and suggested that banks in Ohio were closed, when in fact no commercial bank in the state of Ohio was affected either by the "holiday" or is insured by the state of Ohio. Reluctantly, commercial bankers recognize that the term "bank" is generically used in our contemporary society to describe not only the 14,000 full service commercial banks, but also the 3,500 savings and loans and federal savings banks, and in agricultural communities — even the Farmers Home Administration and the Farm Credit System.

While everyone seems to want to use the name "bank" in their title, and we do accept the view that imitation is the sincerest form of flattery, the reality of our legal situation, as this Committee

knows, is that commercial banks are treated in many ways more stringently than our competitors.

The net worth guarantee program, for example, is a clear case in point. Bank regulators have traditionally emphasized the need for capital. Recently, all three bank regulatory agencies have published regulations to increase the amount of capital required for banks. Meanwhile at the Federal Home Loan Bank Board, although Chairman Gray has committed the Agency to increasing capital standards for the thrift industry, the fact remains that the vast majority of their capital comes from net worth guarantees, so-called regulatory accounting principles and "good will". In the marketplace, thrifts using net worth guarantees are aggressively competing with banks for deposits and loan business. Clearly, the institution which does not have to buy its capital in the marketplace or retain it out of earnings, has significant competitive advantages.

ABA, therefore, strongly recommends changing the net worth certificate program to remedy what we perceive as inequitable operating advantages in the present structure of the program. Specifically, we support a statutory requirement that thrifts achieve the same capital and accounting standards over a reasonable period of time as required of commercial banks. If the term "bank" is to be freely used in the public marketplace as a marketing tool by institutions unchartered as commercial banks, we believe that the public should not have to guess about the capital standard of one type of institution versus another. While we recognize that it will take many years for the thrift industry to achieve the same capital level of banking, many individual savings and loans institutions not involved with using capital certificates

already have capital levels in line with the commercial banks with which they compete. It is unfair that well-capitalized banks and thrifts alike should have to compete against institutions that are under no mandatory requirement to increase their capital position.

It has, also, been suggested by the Independent Bankers Association of America along with several Members of Congress that the capital certificate program be broadened to include banks with significant agriculture loan portfolios. There is certainly merit to this proposal in that banks who extended credit to their farm customers are not materially different from institutions which provided mortgage credit to American home buyers. Our national policy has a long tradition of encouraging financial institutions to lend to American families to buy a home or operate a farm. It is also the view of our Association that use of net worth certificates undermine the principal of private capital adequacy. Our preference as indicated is that the rules for adequate capital be equitably applied among banks, thrift institutions, and other financial entities such as the members of the Farm Credit System. However, to the degree that Congress determines that because of a lender's involvement in mortgage or farm lending, the lending institution should be temporarily dispensed from sound capital requirements, we have no objection to qualifying agriculture banks for eligibility in the net worth program.

FARMERS HOME ADMINISTRATION

The operation of the Farmers Home Administration must be examined in relation to the whole structure of this country's financial institutions and the credit needs of the agriculture section of the

economy. During consideration of the 1985 Farm Bill, the ABA recommends that the credit programs administered by the FmHA be restructured.

Any federal credit activity involves some degree of subsidy. A subsidy is granted when a borrower obtains funds at an interest rate lower than would have been paid for a comparable private sector loan or one not covered by a federal guarantee. Plus the administrative cost for personnel to perform the loan-making and servicing functions must be added.

However, the insured loan program of FmHA is much more dependent on government funding and commmands more of a subsidy than does the guaranteed loan program where the loans are provided by private lenders. We believe more of each year's appropriations should be used for loan guarantees in lieu of direct lending by FmHA.

Three major issues need to be resolved in the guarantee program: the timely processing of gurantee loans, the consistent applicaton of FmHA regulations at the state and local county levels, and a commitment by FmHA to honoring the guarantee in the event of default. Deputy Under Secretary of Agriculture, Kathleen Lawrence, has agreed to participate in an agricultural commerical lenders task force to reevaluate the FmHA guarantee and address our concerns. Let me highlight in more detail the issue of confidence in the FmHA guarantee.

In order to resove the lack of confidence regarding the collection of the FmHA guarantees in the event of default, we believe that procedures must be modified for more expeditious payment with fewer comlicating restrictions. The common perception that guarantees through FmHA are not collectable or at best undesirable due to the

required complete liquidation of assets prior to any disbursements must be addressed. If the guarantee must be exercised and the lender has followed prudent lending practices, then FmHA should reimburse the lender to the full extent of the guarantee. A procedure for liquidation similar to that offered under the Small Business Administration guaranteed loan programs should be implemented allowing for early disbursements of guaranteed proceeds based on expected liquidation values.

ABA strongly supports the provision in S.616, the Agriculture, Food and Trade Act of 1985, which gradually raises the interest rate for current insured operating loan and farm ownership loans to commercial lending rates and all interest rates currently provided through FmHA would be raised to the prevailing private sector rate.

We do want to comment on another important program affecting farmers and their lenders -- the Farmers Home Administration's Debt Adjustment Program (DAP). The ABA advocated adding an interest rate write-down to the principal write-down proposed by the Administration last fall. We supported this alternative because rural agricultural banks could not afford to reduce their bank capital accounts.

The effect on capital was a major reason for banks' lack of involvement in the initial DAP. Write-offs of principal could reduce bank capital below the capital adequacy ratios acceptable to bank regulators. Agricultural banks are particularly sensitive to bank examinations at present because many small banks are being forced to sign cease-and-desist orders and other enforcement agreements that place onerous burdens on the banks and their management until capital positions are returned to normal levels. An interest rate alternative

to the principal write-down avoids this capital problem for small banks and allows the banks to assist more agricultural borrowers.

Banks want to work with their farm borrowers. We are willing to reduce farmers' payments. However, we propose reducing the interest rates and our income rather than writing down principal and lowering our capital.

Congressional attention to the agricultural situation has resulted in the addition of an interest rate write-down to the DAP and the adoption of provisions that follow closely recommendations made by the Agricultural Bankers Division of the ABA. These provisions include: reduced cash flow requirements; an extended period of time over which loans can be restructured; and improved guarantee provisions. Further, the Administration has stated that additional guaranteed funds will be provided if needed.

The problem we face now is that we are in the spring planting season. Farmers need operating capital now, and in many states and localities the Farmers Home Administration (FmHA) is not processing the DAP applications expeditiously. In fact, 55% of the respondents to our Agricultural Bankers Division survey indicated that it now takes from 90 to 120 days for an FmHA loan to be approved. Effective loan processing of less than 30 days must be in place at FmHA county office if any government approved loan restructuring plan is to work.

USDA has now liberalized the Approved Lender Program (ALP) allowing most Federal Land Banks and Production Credit Associations, in addition to some commercial lenders, to qualify. It is unfortunate that this announcement was made on the 20th of March rather than in September of last year. The number of ALP's has significantly

increased since last May, but the program will only work if it is enthusiastically implemented by the Farmers Home Administration at the federal, state and local levels.

However, even with the difficulties which have occurred, use of the regular guarantee is at an all time high and should exceed $400 million by May 1st.

FARM CREDIT SYSTEM

Senator Zorinsky, in close cooperation with the Farm Credit Administration (FCA), has introduced S. 466, a bill which would grant FCA new authorities to 1) issue cease-and-desist orders, 2) levy civil money penalties, 3) remove officers and directors of system institutions, and 4) sue and be sued. In some cases, these authorities comprise broad and expanded powers which when combined exeed those possessed by other federal or state financial regulators.

Our concern with these new powers is that the proposal places both management and regulation under the same FCA roof of the Farm Credit System, Congress should consider these proposed new powers carefully in order to protect the rights and autonomy of the local farmer cooperative member and at the same time keep the FCS financially strong and viable.

FARM CREDIT COUNCIL'S
PROPOSED AGRICULTURAL CONSERVATION CORPORATION (ACC)

The ABA is interested in exploring a varicty of solutions to what is a major problem in the agricultural economy: declining land values.

It is of great importance to address this problem, particularly for the Midwest. Referring again to USDA's report on the current financial condition of farmers and farm lenders, "debt considered adequately secured in 1980 may no longer be so, because farm land values have failed to rise as expected, and have dropped by as much as 28% in some corn belt states". Today, the decline exceeds 50% in many areas.

In that context proposals for responses such as that offered by the ACC should be carefully examined. The Government Relations Agricultural Task Force, of which I am a member, did explore some aspects of this proposal at two recent meetings and will consider it again at a meeting in mid May. Based on our initial review, we do have some questions that should be explored as this proposal is considered.

One primary consideration is the probable cost of any such program. Further, we believe careful analysis must be given to the amount of land that might be involved in this proposed corporation and the types of agricultural lenders who can participate.

The ABA through its Government Relations Agriculture Task Force and the Agricultural Bankers Division will continue to explore this and other proposals designed to slow the rapid deflation in land values that are affecting the viability of agricultural credit.

Secondary Market for Agricultural Loans

Due to the current agricultural situation, a farmer's long term financing options and resources for creating positive cashflows are extremely limited. Agricultural banks are exploring options for other sources of long term credit, beyond traditional sources, which could provide competitive and stable funds for American farmers. ABA looks

forward to working with Congress, the Administration, and other interested groups, in formulating proposals in this area.

CLEAR TITLE FOR AGRICULTURAL PRODUCTS (S. 744 and H.R. 1591)

Mr. Chairman, let me say at the beginning of my testimony on these bills pertaining to the the farm products exception of the Uniform Commercial Code that the ABA appreciates the fact that Congressmen Gunderson and Stenholm, Senators Cochran and Boren, and others, as well as representatives of various groups supporting this bill have indicated a desire to meet with us to work out a compromise on this very important issue. However, the bills that have been introduced are not a compromise position. Let me discuss the current legislation and American Bankers Association's compromise proposal.

It is true that the bills do not simply eliminate the farm products exception. However, it would shift the burden of notification to the lenders who will not only have increased paperwork but also could never be sure that the list of potential buyers provided by a farm borrower would indeed cover the final, actual buyer of the farm products against which the original lien was placed. Also, there are no provisions in the bill enumerating specific sanctions against the farm borrower who sells a farm product against which a lien is pending. Therefore, the effect of these bills would be almost the same as eliminating the farm products exception altogether.

The significance of the exemption has been that farm commodities are sold in bulk and once sold, the commodities cease to exist or change form and are not normally replaced in inventory. They cannot be traced or differentiated. In other words, the lien cannot follow the

goods.

Further, without having the producer, lender and buyer share the risk of a commodity transaction, there could be a substantial reduction in the willingness of creditors to lend to farmers. In order to attain the same level of protection against default which is provided by the farm products exception, lenders would be forced to seek more collateral for their loans or to lend only to those farmers who qualify for unsecured loans. In either case, the cost of credit would increase while the overall amount of available farm credit would be reduced. Some high risk farmers will be unable to obtain credit from traditional credit sources. These bills, while granting purchasers of farm products protection, would punish a great number of lenders and honest farmers for the acts of the few unscrupulous agricultural borrowers who do not repay their loans.

The American Bankers Association understands that the growing and rapidly changing marketplace for agricultural goods has created complexities for both lenders in knowing the purchasers of their borrowers' products, and buyers in discovering the existence of recorded liens. This is why the ABA's Agricultural Bankers Division, through our Government Relations Task Force on Agriculture, has developed major technical adjustments to the Uniform Commerical Code's "Farm Products Exception" which provides a sharing of risks.

The six major provisions work in the following manner:

1) When a borrower takes out a loan, the lender provides a certificate to the borrower stating the existence of a lien, signed by both parties, on which the penalties for violation of the law are stated.

2) At the point of sale, the buyer requests from the seller this certificate stating there is no lien on the farm products to be bought. Upon receipt of the certificate, if the buyer issues a multi-party check listing the lien holders, the buyer may take possession of the property free of security interests.

3) If the seller has no certificate, the buyer should receive a written statement that no lien exists against the farm products to be purchased, and retains it on file for two years.

4) If the buyer receives a written statement that no lien exists at the point of sale, he may take possession of the property with no security interest.

5) The statute of limitation for action by the lender, under our proposal, is reduced from five to two years.

6) Our proposal calls for stringent criminal penalties for fraud in addition to maintaining the security interest during bankruptcy proceedings.

We believe this approach offers a balance and equitable sharing of responsibility between seller, lender, and buyer. ABA looks forward to working with this Committee and other Senators and Congressmen towards a reasonable compromise on this proposal.

ALTERNATIVE MINIMUM TAX

Tax issues, I realize, are not under your Banking Committee's jurisdiction. However, I want to comment briefly on a serious problem facing agriculture which directly affects farmers, agricultural suppliers, and lenders. That issue is an artificial or "paper" equity gain through inflation which results in large capital gains at the time

of a farm liquidation.

If the farmer makes a decision to voluntarily deed the property to the lender or voluntarily sell the property, he can create a very large paper capital gain between his original sale price and the asset's present value. In today's environment, the debt often equals or exceeds the value of the assets. In reality, he has made no capital gains profit. However, the IRS does not see it that way.

Consequently, to avoid the potential IRS tax, the farmer files bankruptcy. All parties affiliated with the banker lose in this situation -- the lenders are involved in extensive negotiations with asset values continuing to decline, the federal bankruptcy courts are caught in processing additional caseloads, and the farmers are placed in untenable no win situation.

When a farmer's loan debt exceeds the current value, the federal government in many cases would be better to forego the unrealized capital gains and move the asset to another operator with a positive cashflow situation.

BANKRUPTCY

Though the bankruptcy statutes are not under the Banking Committee's jurisdiction, the Committee should be aware of pending legislation. Agricultural bankers are just as dependent on farmers for repayment of their loans as the farmers are on the bankers for their crop financing. The symbiotic nature of this relationship and the direct impact that farm bankruptcies have on viability of farm lenders, must be kept firmly in mind during the analysis of these proposed bills. Any proposal that attempts to shift an inordinate portion of

the economic burden to the bank is not a viable approach since the net effect will be to jeopardize both the viability of agricultural banks, and the continued availability of financing for all farmers. Currently two bills have been introduced in the House which would allow farmers to file under Chapter 13 as well as the widely used Chapters 7 and 11.

A key factor that needs to be considered is the precendential value of establishing another limited constituency with special rights in bankruptcy (municipalities, railroads, etc.). Each of these groups is fairly limited in number, has unique characteristics, and longstanding public policy reasons behind their special status.

We must also consider the individuals who would be affected by the legislation, the "family farmer", and ask whether these farmers generally have a regular income, for whom Chapter 13 was designed, or more like a business, for whom Chapter 11 was designed.

It has been my experience that farmers with up to a million dollars in debt are generally of a size that they are and should be considered more like businesses than family farms. Even though the farm may be the sole or primary income for the family, the farm itself needs to be, and is in most cases, run like a business. That being the case, we strongly question whether or not we should try and "shoehorn" agricultural businessmen into a form of bankruptcy designed for wage earners.

If Chapter 11 of the Bankruptcy Code was designed to handle the business bankruptcy and now presents deficiencies specifically related to the family farm business, we wonder whether it wouldn't be better to attempt to address the deficiencies within Chapter 11? Finally, we need to remember that the ink is barely dry on the 1984 amendments to

the Bankruptcy Code.

One problem of which any participant in the bankruptcy process must be aware is the acute shortage of bankruptcy judges. In any bankruptcy, time is of the essence. It is imperative that the reorganization or liquidation process be commenced rapidly, yet many times cases take months to be heard. Expediting this process would certainly be a great help.

FOOD STAMP HANDLING CHARGES

Let me briefly address bills introduced by Congressman Panetta and Senator Durenberger which would prohibit financial institutions from charging retail food stores service charges for redeeming food stamps. Food stamp processing costs to banks have risen in recent years as have virtually all other bank costs. In addition, deregulation of deposit interest rates has made the provision of free services of under-priced services by the banking industry much less widespread than in past years. The increase in interest costs on the industry has resulted in intense pressure on the spreads between interest earned on loans and that paid on deposit accounts. As a consequence, banks have been forced to increase their charges on the products that they sell to begin to recover the costs of these products. As a result, today many merchants are experiencing new or increased costs for their food stamp deposits. Our Association believes that virtually all of these increased charges are directly related to banks' increased processing costs and are in line with increased charges imposed on deposits of cash and checks.

CONCLUSION

American Bankers Association supports the goal of reducing government's role in agriculture. Nevertheless, with today's fragile agricultural economy, any rapid and major shift to market orientation, or significant decline in price and loan support levels could be disastrous, especially in the central grain producing states. Farmers, agricultural suppliers, and creditors must be given time to adjust to the current environment of deflation of assets, high real interest rates, and the over-priced dollar.

ABA encourages additional emphasis on export incentives for farm commodities versus the heavy reliance on internal supply controls. To maintain a strong American agricultural sector, new and expanded foreign markets must be encouraged and developed.

To provide farmers with ample long-term credit at reasonable rates and terms, an agricultural secondary mortgage market for commercial banks should be given serious consideration.

While agricultural lenders can not provide credit to all farm borrowers under current economic conditions, ABA supports the movement by USDA to move FMHA from direct insured loan programs to a guarantee loan program. Today, many FmHA borrowers are potential sources for commercial loans and with a reduction in the overall FmHA direct loan program, less federal tax dollars are needed. As I mentioned earlier, the guarantee program must be viable and consistent.

As I previously stated, ABA strongly favors USDA and Congress reducing the subsidized interest rates to FmHA direct insured borrowers. All farmers should be competing on equal footing to receive

agricultural credit.

Mr. Chairman, I am deeply troubled about the lower one third of the American farm economy: its structure, its existence during the next few years and the impact of its instability on rural communities and banking. Our ABA survey (Attachment I), completed in January of this year stated that bankers would be unable to extend additional credit to 15% of their farmers this year based on existing conditions. Of course, this survey was conducted prior to the additional changes in the FmHA guarantee program announced in February and March 1985.

Let me expand briefly upon this 15% group and where they are today: Five percent have left or are in the process of leaving farming. Five percent are now obtaining financing through FmHA, other local creditors, or seed and fertilizer dealers. And five percent are still attempting to survive.

My biggest concern today as this agricultural evolution continues are the legal entanglements which are growing at an alarming rate, and could set unwise legal precedents which will compound our lending problems. In this scenario, local community support for agricultural lending and particularly the banking industry is not strong. Let me state three recent examples which make my case.

A bank near my hometown in Iowa is currently in a foreclosure proceeding on a $650,000 loan. The farmer has filed a counter suit against the bank for $6.5 million citing fourteen counts where the bank failed to provide adequate supervision and credit.

In another instance, a farmer sued a lender for $5 million claiming bad advice on a marketing procedure. The court awarded a $1 million settlement to the farmer.

Recently, a farmer sued a bank for not completely honoring a verbal agreement for a loan advance. The farmer was awarded $70,000. These three cases, if the decisions rendered are not reversed, set a dangerous precedent and will no doubt have a great impact on the ability of all agricultural lenders to provide credit.

A large majority of FmHA loan guarantees written in the last few months have been based on the extension of current farm programs. In many cases the debt restructuring has been rescheduled over 15-30 year paybacks. What will be the status of the USDA guarantees if the farm economy continues to decline or farm programs are significantly altered?

Mr. Chairman, Members of the Committee, today the commercial banking industry has a major stake in the agricultural economy because the commercial banks provide approximately $40 billion or 65% of operating loans to farmers (Attachment III). The ABA will continue to work with the Senate Banking Committee as you address the important task of providing the framework for a strong agricultural financial network. We are committed to working with our farm borrowers and with you, Members of Congress, to develop and to implement effective credit programs that will contribute to a long term, profitable agricultural economy. It will not be easy. The current economic situation of agriculture has resulted in a constant focus on short term responses to pressing needs in particular sections of the country.

I have discussed a number of important items today. Nevertheless, the quickest way to a sound farm economy is through lower interest rates and more realistic international exchange rates. We believe the over-valued dollar and high interest rates, precipitated by

federal government runaway spending, is the two edged sword posed to deliver the final blow to America's agricultural sector. We must all step back and look at the longer range and the bigger picture. Some agricultural issues can be addressed in the 1985 Farm Bill, but the much larger issues remain with the overall Congressional budget, authorization and appropriation process currently underway. As you work on legislation in 1985, we at the ABA will provide you with input, reaction, and support for policies that contribute to aiding the most productive agricultural economy in the world.

I thank you for the opportunity to testify before you today. I will be pleased to answer any questions you may have.

ATTACHMENT I

Estimated Number of Farms With Cash
Shortfalls by Sales Class and Debt/Asset Ratio, 1983
Debt to Asset Ratio

Sales Class	0-40%	40-70%	Over 70%	Total Farms
$500,000 and over	16,400	5,200	4,500	26,100
$250,000 - 499,999	61,600	17,600	11,000	90,200
$100,000 - 249,999	209,000	52,800	26,400	79,200
$ 50,000 - 99,999	230,300	44,000	26,400	300,700
$ 25,000 - 49,999	224,400	26,400	22,000	272,800
$ 10,000 - 24,999	327,800	30,000	16,400	374,200
Less than $10,000	730,400	66,800	36,400	833,600

Memo Total Farms 2,185,800

Source: USDA

:WS•NEWS•NEWS•NEWS•NEWS•NEWS•NEWS•NEWS•NEWS•NE\
AMERICAN BANKERS ASSOCIATION • COMMUNICATIONS GROUP • 1120 CONNECTICUT AVENUE, NW • WASHINGTON, DC 20036

ATTACHMENT II

CONTACT: Sheldon D. Golub
(202) 467-4338 (Office)

FOR IMMEDIATE RELEASE
(85)

ABA AGRICULTURAL BANKERS SURVEY
SHOWS SCOPE OF CREDIT SITUATION

WASHINGTON, DC, February 28 — Agricultural bankers surveyed by the American Bankers Association (ABA) indicate that 14 percent of their farm borrowers will not receive continued operating credit for the 1985 production season as a result of deteriorated financial conditions.

Approximately 800 ABA member bankers representing a cross section of agricultural banks, with 20 percent or more of their lending devoted to agriculture, responded to the ABA survey sent out in January. Responses were returned quickly, particularly from the 580 banks responding from the midwest farm states where many banks concentrate their lending to farmers and where financial conditions for those farmers have shown the greatest deterioration.

Half of the responding bankers, fifty percent, say that overall financial conditions or net worth of their farm borrowers show "some deterioration" over the previous year, while another 37 percent of the respondents indicate that there is "substantial deterioration."

More than one third, approximately 41 percent, of farm borrowers had a negative net farm income during 1984, the bankers indicate. They anticipate that approximately 37 percent of the farm borrowers will have a negative net farm income in 1985.

Bankers identify that 24 percent of their farm borrowers have weak credit and are receiving special attention, while another 10 percent are considered very weak and show a potential for loss.

Most bankers, 82 percent, indicate that they were examined during the last 12 months and nearly that same number, 78 percent, state that examiners were knowledgeable of agricultural credits and had an understanding of the problems within the agricultural community. However, given the financial stress of the agricultural community, half of the respondents, 52 percent, say that there is significant increase in classified agricultural loans in their portfolios.

ABA Agricultural Bankers Executive Committee members have worked closely with banking examiners during the last two years to raise awareness of the agricultural situation and identify that bankers are working closely with their farm customers to restructure loan portfolios where necessary.

Related to the Administration's Farm Debt Restructuring and Assistance Program, only 53 percent of the bankers indicate a willingness to use the program as it was originally proposed with a minimum 10 percent write-off of the loan principal, while 82 percent of the bankers indicate their willingness to use the program if it contains an interest rate write-down. Bankers indicate that they would assist 8.4 percent of their eligible borrowers with a program that offered a principal write-off, but double that number, 16 percent, if the program contains an interest rate write-down provision.

A message from 55 percent of respondents is that it takes between 90 to more than 120 days from the time an FmHA loan application is made and the time it is approved. In testimony before House and Senate Agricultural Committees, the ABA has asked that more resources must be available and effective loan processes be in place at county offices if any government-approved loan package is to work.

The ABA bankers have consistently stated that the quickest and most effective response to the current agricultural credit situation is through debt restructuring which addresses a farmer's existing debt position as well as future

operating credit needs, while having a minimal impact on the federal deficit.

ABA agricultural bankers also indicate that an interest rate write-down with a loan guarantee of 90 percent on the full principal is a preferred proposal versus the Administration's proposal which provides a maximum guarantee on not more than 80 percent of the original loan.

The American Bankers Association is the national trade and professional association for America's Full Service Banks. Of its nearly 13,000 member banks, representing approximately 95 percent of the combined assets of the industry total, approximately 5,200 banks are considered agricultural banks, having 20 percent or more of their loans devoted to agriculture. Nearly 7,000 ABA member banks provide some lending to agriculture.

# # #

SPECIAL INFORMAL SURVEY
AGRICULTURAL CREDIT CONDITIONS AND BANK EXAMINATIONS
AMERICAN BANKERS ASSOCIATION

Early in January of this year, the Agricultural Bankers Division of the ABA mailed a survey to 2775 agricultural banks randomly selected from across the country. The objective of the survey was to obtain an assessment of financial conditions in agriculture, as well as to develop information pertaining to the relationship of banks with their examiners and the Farmers Home Administration. Most of the respondents replied in January so they had no prior knowledge of recent administration or congressional initiatives affecting agriculture.

The total number of responses received was 794. The vast majority of responses (582) came from the midwestern region, followed by the southern region (124), the western region (65) and the northeastern region (23).

The results of the survey are presented below. The results for each question are presented with the unweighted average shown as a percentage of total respondents to a particular item.

I. FINANCIAL CONDITIONS

A. Please indicate the change in the overall financial conditions (net worth) of your farm borrowers as you review their year-end 1984 statements compared to a year ago. Check one:

0 Substantial Improvement	50% Some Deterioration
5% Some Improvement	37% Substantial Deterioration
8% Essentially No Change	

B. If you checked either some or substantial deterioration, please indicate the proportion of your farm borrowers that would fall into these categories. Check one:

7% Under 10 percent	37% 26-50 percent
30%10-25 percent	26% Over 50 percent

C. What percent of your farm borrowers had a negative net farm income during 1984? 41 %. What percent of your farm borrowers do you anticipate will have a negative net farm income in 1985? 37 %.

D. What percent of your farm borrowers fall within the following categories?

63 % Being given normal supervision
24 % Identified as a weak credit and receiving special attention
10 % Identified as a very weak credit with potential for loss
3 % Foreclosure and/or bankruptcy in progress or imminent

E. For what percentage of your farm borrowers will your bank be unable to continue providing operating credit for the 1985 production season? 14 %.

F. Will you extend credit in 1985 for farm borrowers to pay maturing installments on land and machinery financed outside your bank?

77 % Yes
23 % No

G. If you checked yes, please indicate the percentage of farm borrowers for whom you will extend this type of credit.

27% over 75 percent	18% 26-49 percent
27% 50-74 percent	28% less than 25 percent

H. Used farm equipment values changed by what percent in your area in 1984? __%

75% of the respondents indicated that used farm equipment declined by an average of 22% in 1984

What will the estimated change by in 1985? __%

72% of the respondents indicated that they expected used farm equipment to decrease by an average of 15% during 1985.

I. Farm real estate values changed by what percent in your area in 1984? __%

76% of those responding indicated that farm real estate values had decreased an average of 19% in 1984.

What will the estimated change be in 1985? __%

69% of those responding indicated that they expected farm real estate to decrease by 11% in 1985.

II. EXAMINATION OF BANK AGRICULTURAL PORTFOLIO

A. Have you had a team of examiners look at your loan portfolio in the past twelve (12) months? 82% Yes 18% No

B. If yes, by whom?

29% COC	10% Federal Reserve
34% FDIC	50% State

(Will not total 100% because some banks were examined by more than one regulator.)

C. Were the examiners knowledgeable of agricultural credits and understanding of problems within the agricultural industry?

78% Yes 22% No

D. Did the examiners look at agricultural loans differently than:

a) in past examinations? 57% Yes 43% No
b) other loans in your portfolio? 37% Yes 63% No
c) other regulatory agencies? 18% Yes 82% No

E. Was there a major disparity between your bank's agricultural problem loan list)or watch list) and the findings of the examiners? 12% Yes 88% No

F. Was there a significant increase in classified agricultural loans in your portfolio? 52% Yes 48% No

G. Have you experienced the classification of an ag borrower's whole credit line when only a portion warrants such classification?

51% Yes 49% No

III. FMHA ASSISTANCE

In September, the USDA announced a "Debt Restructuring and Assistance Program." One of the provisions of this program allows for a FmHA guarantee of existing adversely classified loans following the forgiveness of loan principal in an amount that results in a positive cash flow for the farmer. The principal forgiveness cannot be less than 10 percent.

A. What percentage of your eligible farm borrowers would you consider assisting under this program? __%

52% responded that they would consider using the program as announced in September. The average percentage of eligible borrowers for which they would consider utilizing the program was 8.4%.

B. If an interest rate write down were offered as an alternative to principal forgiveness for receiving a FmHA guarantee, what percentage of your eligible farm borrowers would you consider assisting under this program? __%

82% responded that they would consider using the program if some sort of interest rate adjustment alternative were offered. The average percentage of eligible borrowers for which they would consider utilizing this program was 16.0%.

C. What is the response time between application and approval for FmHA loans in your area?

4% within 30 days	26% 91-120 days
27% 31-60 days	31% 121+ days
12% 61-90 days	

D. Would your bank be willing to serve a selected group of FmHA customers for a reasonable fee?

59% Yes
41% No

E. Are you an "approved lender" under the FmHA Approved Lenders Program?

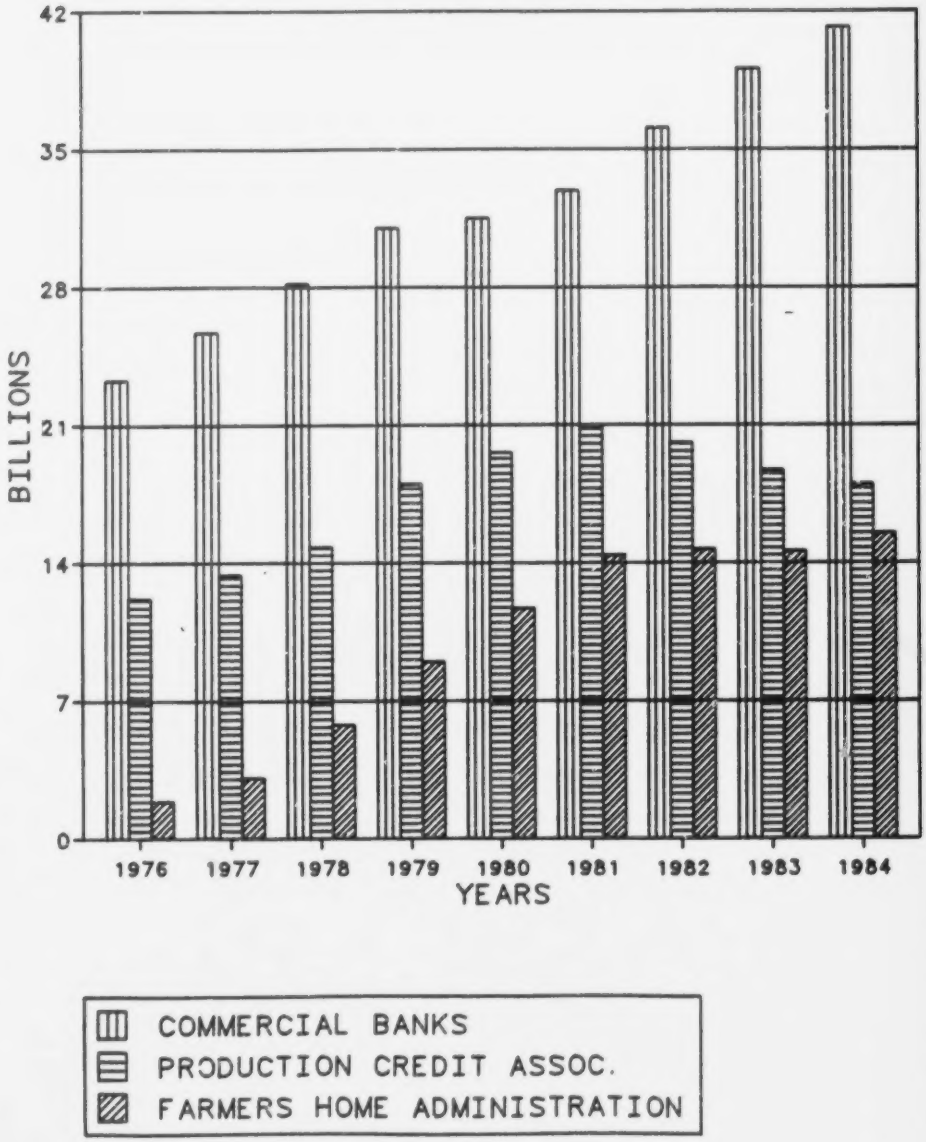
30% Yes
70% No

F. If you answered yes, please indicate the average number of days it takes to receive notice of approval on guarantee requests?

65 days

ATTACHMENT III

NON-REAL ESTATE DEBT OUTSTANDING
AT REPORTING LENDING INSTITUTIONS
1976-1984



Senator GORTON. Thank you.

I am going to ask you a question, Mr. Gerhart, of Mr. Tubbs' testimony, and then he can respond, as well.

He noted that there are 628 banks in Kansas. California has 10 times the population of Kansas and a much more diversified economy, and it has 472 banks.

Does this suggest that branching restriction in Kansas may have led to an uneconomic industry structure?

Mr. GERHART. No, I think it suggests that Kansas is more dependent on agriculture. I know Nebraska is certainly more dependent on agriculture. Is that your question?

Senator GORTON. No, my real question is whether or not branching restrictions which create a very, very large number of very small and independent banks are not—the lifting of some of those restrictions is not a part of the solution to the problems we have been discussing here today.

Mr. GERHART. I would not think they would be, because I think that the larger banks with which I am familiar in Nebraska are really not very interested in these small- and medium-sized farm loans. These are credits that demand a lot of attention, a lot of on-the-scene supervision right now. I think that the large number of local banks out in the country are better able to handle that situation.

Senator GORTON. Mr. Tubbs, do you want to comment?

PERFORMANCE OF SMALL BANKS

Mr. TUBBS. Yes, sir; when we talk about inefficiencies, I think we need to be looking at earnings, and when you look at earnings, the bank performance in the past, you will find that those smaller banks have generally had a higher performance than some of the larger banks. However, the smaller banks have also operated at somewhat of a disadvantage, in terms of a dual standard for capital, because the larger banks, particularly the California banks, have been able to operate on capital standards in the neighborhood of 5 to 6 percent, while the predominant capital level for banks in Kansas, Nebraska, and Iowa have been in the 8 to 10 percent level. Nevertheless, the smaller banks have been able to compete effectively, and I believe this says these are not inefficient bank systems.

Senator GORTON. Mr. Gerhart, what extraordinary measures have IBAA banks taken to maintain adequate levels like sales of bank buildings, other loan portfolios, suspensions of dividends, and the like?

Mr. GERHART. Sales of bank buildings; well, out in Newman Grove, NE, population 800, you can't get too much for a bank building. So I don't see that as being any solution. Other assets, basically, the assets of the banks with which I am familiar, are the loans in their note portfolios that have been made to the farmers and other businessmen in the rural communities. I don't know what assets we could liquidate. The problem is not so much a problem of having funds, it is a problem of having borrowers that are able to pay back those loans. We don't have very much of a liquidi-

ty problem. It is a farm price problem, and not being able to get loans repaid.

Senator GORTON. Your testimony refers to inequities between the treatment of small agricultural banks and large banks like Continental Illinois, and there have been several other references to Continental Illinois here today. I suspect that flat rate premiums amount to a subsidy of small banks by larger banks which are more diversified. Would risk-related premiums for deposit insurance or other means of reducing the subsidy help or hurt your members? Indeed, would your members have been helped if FDIC had allowed Continental Illinois to go under?

Mr. GERHART. The Continental Illinois situation certainly grates on the small bank owners and managers, because it seems that they've been given preferential treatment.

Regarding risk-related FDIC insurance, I'll have to answer that as a banker from Newman Grove, NE. It appeals to me. I have no problem with that at all. I think it would be a fairer way. The larger banks that have been getting into some deep troubles would be paying a bigger part of the FDIC cost, if that were the case. I have no problem with relating the premiums to the risk.

Senator GORTON. Now let's go to the specific proposals which you've made, which Senator Exon has made. Let me ask, if we adopted a Net Worth Certificate Program, what recommendations would you make to minimize the risk to FDIC of an increasing amount of bad loans. Basically, how is time going to change anything other than the size of the defaulted loan portfolio?

REQUIRE NEW MANAGEMENT

Mr. GERHART. I think the FDIC should have, and it is implied in the Senator's bill, that the FDIC should have some controls. One of those controls can certainly be to require new management, where it is needed. As far as the bailing out of these banks' ownership is concerned, this wouldn't give the stockholders of a failing bank or a problem bank any bailout. The stockholders are going to lose their money, if the bank fails immediately. And if the FDIC tries to pump in these certificates, the stockholders still stand to lose all their money. The bank's stockholders are not going to gain anything. What it does do for the community, however, is keep a bank in business that has a chance to survive. We are not suggesting that we do this for banks that have no chance to survive. But for a bank that a has chance to survive, it continues to provide a credit source for the people in that community, the farmers and the businessmen around them.

Right now, when the FDIC takes over those banks, they are interested in only one thing: Getting loans paid or getting them moved to somebody else. If no one else is willing to take those loans, that farmer or small businessman is an orphan, as far as getting his credit placed. He just has no place to go, whereas he would if the bank continued to operate and was required to meet certain management standards. Certainly, some of these banks have not been managed right, and I think the FDIC should and would see to it that they had a change in management policies.

Senator GORTON. Mr. Tubbs, I'd like your comment on essentially the same question, maybe with just a little bit of difference.

Given the rather gloomy forecasts for agriculture, what's going to change the situation of small banks which have an overwhelming dependence on agricultural loans? Is time in and of itself going to do any good or is only what we can do here about the size of that deficit and interest rates really going to be a solution to these problems?

Mr. TUBBS. I believe that what can be done in Congress in terms of the deficit—it's impact on interest rates and our ability to sell overseas—has a larger bearing than anything that we can do out in the country.

These farmers are locked into their situations ——

Senator GORTON. And you're locked into your situation where you are; right?

Mr. TUBBS [continuing]. And we're locked into them and it's going to require time as well as profitability in the agricultural sector. If we don't have that, then even these loans that are guaranteed through Farmer's Home Administration are probably not going to survive and the contingent liability on the part of the Government is going to be fairly great.

Because you have to remember, when these loans were packaged together and restructured, they were restructured over the maximum amount of time that is possible or practical for amortization. They were based on reasonable crop yields and the current farm program that's in existence right now.

Today, we're looking at income prospects for 1 year and we're projecting those over 15 to 30 years for amortization. Things have to click very well for them to work out of those situations unless we see some positive changes in the performance of the farm economy.

And therefore, the overriding factors are the farm program for 1985 and beyond, what happens with our ability to compete in the world markets and the general level of interest rates.

Senator GORTON. Mr. Gerhart, would you agree with that statement?

Mr. GERHART. Yes.

Senator GORTON. Thank you both very, very much. You've been extremely helpful to us.

Senator Dodd, do you have any questions for these witnesses?

Senator DODD. No, no, and I apologize, Mr. Chairman. I'll catch up in the testimony.

Senator GORTON. OK. Thank you.

We have someone to hear panel 4. We'll turn it over to Senator Dodd.

Senator DODD [presiding]. This is a rare opportunity for a Democrat to have a gavel in his hands. I like the feel of that thing. [Laughter.]

All right. Well, welcome, gentlemen, this morning to the committee and why don't we just—I'll begin with Mr. Madsen, if I can. We welcome you this morning, sir; Mr. Meadows and Mr. Downey. And why don't each of you in your own way begin. I presume you have some prepared testimony and if you want to paraphrase that or ab-

breviate in any way, I'll leave that up to you and we'll accept your prepared testimony as read, as well.

So, Mr. Madsen we welcome you, and thank you for coming before the committee.

STATEMENT OF WALTER MADSEN, SUPERINTENDENT OF BANKS FOR THE STATE OF ARIZONA, PRESIDENT AND CHAIRMAN OF THE CONFERENCE OF STATE BANK SUPERVISORS; ON BEHALF OF ROGER BEVERAGE, DIRECTOR, NEBRASKA DEPARTMENT OF BANKING AND FINANCE, REPRESENTING THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. MADSEN. As you know, I'm a late-minute replacement for Mr. Beverage from the State of Nebraska in presenting testimony today.

Until recently, agricultural banks were one of the most stable components of our banking system. However, that is no longer the case. Agricultural banks currently make up a disproportionate share of all recent bank failures and all indications are that this trend will continue.

FARM HEALTH UNDERMINED BY FOUR VARIABLES

Farm belt banks that would not otherwise be classified as troubled are being affected by four variables which are undermining their health. First, crop production and prices have been insufficient to generate revenues adequate to make timely repayments of debt. Second, marketability of crops has been hurt by the strength of the dollar. Third, persistently high interest rates have affected all capital-intensive industries, farming included. And, finally, the increase in land values that occurred in the 1970's—at least some of which was due to speculation—was unsustainable. The result can be seen both in the increase in delinquent loans and in the reduction of value of collateral--land and farm equipment—which secures these loans.

Questions of farm policy, international trade and monetary policy, are certainly beyond the scope of State bank regulators. While unable to affect solutions to these nationwide problems, State regulators responsibilities and authorities are still quite large.

I and my fellow regulators in their respective States must carry out our responsibilities with due respect to the health of local communities as well as for the expeditious and cost-effective closing of failed banks.

It is impossible to say whether regulators could have or should have spotted lending problems earlier but the decline in land values and other collateral have been precipitous in farm areas. Farmers have seen their assets evaporate in terms of value almost overnight and it has shown up when bank loans are evaluated.

In the near term, State regulators have played a variety of roles in handling the agricultural debt problem. They have increased the level of communication with bank management so as to resolve developing problems as early as possible. They have worked with the Federal agencies, PCA's, land banks, and agricultural associations to coordinate the efforts of all of these groups. and in some cases,

they have helped develop the information by which the depth of the problem could be measured.

Increased examiner skills are certainly necessary to ensure a timely response to development such as the agricultural credit problem. State bank regulators are consistently improving the expertise of their staffs and, indeed, CSBS operates a substantial number of programs as is illustrated in our attached materials. The table shows that CSBS training programs have grown from 4 enrolling 283 examiners in 1978, to 21 programs which will train over 820 examiners this year.

In addition to training programs, the overall quality of supervision of both troubled and nontroubled State-chartered institutions is being strengthened. The CSBS self-evaluation and accreditation programs are also described in attachments to my written testimony.

The existence of education and overall improvement programs certainly does not solve the agricultural lending program problem or any other problem based on outside factors, but such programs do allow regulators to play their proper role when a problem like this one arises.

In short, the regulatory agency has its place but it also has its limits. Macroeconomic variables cannot be overcome by regulatory fiat.

STATE'S ROLE AS PRIMARY REGULATOR

In the context of today's hearing, a few comments about the State role as the primary regulator of State-chartered institutions are in order.

First, the chartering authorities have a broad interest in the overall safety, soundness, and integrity of the financial institutions of the communities and their States.

Second, State supervisory knowledge of the community is a valuable resource and combined with the broad responsibilities of the primary regulator, this knowledge can help State regulators play an important part in legislatively designed solutions.

Third, the quality of State regulation is high and State bank regulators are striving to improve both people and procedures.

Fourth, suggestions as to regulatory restructuring which would lead to an increased ability on the part of the Federal agencies to focus their attention on problem areas are meritorious.

The consideration of possible solutions to the agricultural credit problem involving a large infusion of amounts of capital by means of grants, loans, or purchases of existing agricultural loans which would certainly help ensure the survival of many agriculture banks. Such a program, coupled with changes in the fundamental factors which caused this problem, could be an effective solution. However, given budget realities such programs are highly unlikely.

If a direct infusion of cash is impossible, policy options become increasingly complicated. For noncash programs, a careful weighing of short-term benefits and long-run costs is necessary.

Net worth certificates have been suggested as one possible noncash solution. Under such a program, net worth certificates would

be issued by the FDIC to agricultural banks as capital falls below acceptable levels.

In the short run, such a tool would be of tremendous importance in helping maintain a high level of public confidence in our banking system. It would allow us some of the time we need to help our banks and other financial institutions gain some breathing room. Because such a program is now in place for thrifts, another short-run advantage is that the reduced time this program would take to initiate.

Against this, of course, must we weighed the long-term consideration that net worth certificates do not solve any fundamental problems. They, indeed, only buy time. If farm conditions do not improve, business practices do not change, and private capitalization of the troubled banks do not increase, the time bought by the certificates may, in some cases, only exacerbate the problem.

In summary, a large number of failures have occurred in banks with a concentration of loans related to agriculture. The effect of such failures has a direct bearing on communities throughout the country, reinforcing the macroeconomic problems which initially caused the failures.

In coping with these problems, State regulators contribute experience, responsibility, and authority which can help to address some aspects of the problem.

Unfortunately, however, in addressing a problem arising from nationwide economic factors, success of regulatory efforts depend on changes in these underlying factors.

Thank you, Mr. Chairman.

[The complete prepared statement of Mr. Beverage follows:]

STATEMENT OF MR. ROGER BEVERAGE

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER AFFAIRS

COMMITTEE ON BANKING, HOUSING AND
CONSUMER AFFAIRS

U.S. SENATE

RE: PROBLEMS BEING EXPERIENCED BY
AGRICULTURAL BANKS, WITH EMPHASIS ON
IMPLICATIONS FOR BANK SUPERVISION
AND REGULATION

APRIL 26, 1985

Mr. Chairman, members of the Committee, I am Roger Beverage, Director of the Department of Banking and Finance for the State of Nebraska and a member of the Conference of State Bank Supervisors,on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the primary source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee on the agricultural credit problem, the role of bank regulation and possible measures which would ameliorate the problem.

Nature of the Problem

As you are aware the American commercial banking system is remarkably diverse. There are nearly 15,000 commercial banks, which range in size from multi-billion dollar institutions serving international markets to small community banks serving primarily their own towns and neighborhoods. Of those 15,000 banks, over 10,000 are chartered, examined, supervised and regulated by state banking authorities, with the remainder chartered by the Comptroller of the Currency. Approximately 4,000 of these institutions are agricultural banks, with 25% or more of their assets in loans related to agriculture.

Until recently, agricultural banks were one of the most stable components of the banking system. That is no longer the case. Agricultural banks have made up a disproportionate share of recent bank failures and all indications are that this trend will continue.

In the past two years the number of bank failures has reached post-depression records. Last year's 79 bank failures may be matched again this year, based on the 20 failures which have occurred in the first three months of this year. These failures suggest a system under excessive strain. The total of 79 failures during last year is greater than the 67 institutions which failed for the entire period of 1960-1974.

The majority of bank failures have historically been attributed to fraud, improper loans to bank-related individuals and managerial weakness. In current failures it is possible to discover some of all these elements. However, the best evidence with regard to agricultural bank failures suggests that something else is happening.

Farm belt banks, which would not otherwise be classified as troubled, are being affected by four variables which are undermining their health. First, crop production and prices have been insufficient to generate revenues adequate to make timely repayments of debt. Second, marketability of crops has been adversely affected by the strength of the dollar. Third, persistantly high interest rates reflecting a successful fight against inflation by monetary authorities have affected all

47-312 O—85——5

capital-intensive industries, farming included. Finally, the increase in land values that occurred in the 1970's, at least some of which was due to the speculation, was unsustainable. To the extent a bank is located in communities heavily oriented towards agriculture, it runs the risk of facing financial pressures itself. These pressures are felt both in the increase in delinquent loans and in a reduction in the value of collateral--land and farm equipment--which secures these loans.

In Nebraska, most banks would qualify as "agricultural banks" since they have twenty-five per cent or more of their loans involved with the production of food. Indeed, there is hardly a business up and down the streets of rural Nebraska which is not directly or indirectly affected whenever agriculture faces a decline, and these businesses are also highly dependent on the viability of the local community bank.

The failure of an agricultural bank produces a horrible ripple-effect across the area's economy. It directly affects the local grocer, the co-op, the local gas station, and any agribusiness enterprise which serves the affected community. The indirect effect on attitudes of the local citizens and businesses is much more subtle but nevertheless extremely significant.

The Role of Bank Regulation

Questions of farm policy, international trade and monetary policy are beyond the scope of state bank regulators, the FDIC and the OCC. While unable to affect solutions to these nationwide problems, regulators' responsibilities and authorities are

still quite large.

Each state bank department (SBD) is charged with a broad public interest responsibility toward the entire community served by the banks the agency regulates. This responsibility is shared by the Office of the Comptroller of the Currency (OCC) as the regulator of national banks. As primary regulators, the SBD and the OCC have a continuing, significant interest in the effects generated by the sale or closing of troubled agricultural institutions.

I, and my fellow regulators in their respective states, must carry out our responsibilities with due respect for the health of these communities as well as for the expeditious and cost-effective closing of failed banks.

One problem that we have experienced in Nebraska and that is confronting regulators in other states, as well, is the decline in public confidence in our financial institutions. The Federal Deposit Insurance Corporation, with whom we have worked closely, has received a great deal of criticism in our state for the way in which they have attempted to conduct the affairs of the receivership for the banks which we have closed.

This criticism is unfair. The FDIC is, we believe, pursuing its limited role as an insuror, as it understands the requirements of statutory authority. As an insuror it is striving to preserve the assets of the insurance fund.

In its role as receiver for a closed bank, the FDIC has as its ultimate responsibility the liquidation of the former bank's

assets. The liquidation process does not always work smoothly. In my state, for example, borrowers who now have to deal with the FDIC are not as attentive to the collateral as they were when dealing with the management of the former banks. In many instances the collateral simply "disappears". Such a scenario results in everyone losing: the FDIC, the local community, state government, the banking community and the cause of agriculture. Nevertheless, the perception that the FDIC is somehow the "bad guy" is a very real factor with which we have to deal if we are to keep the public confidence level high. With this in mind, legislative solutions this committee considers may serve multiple ends by keeping liquidation of farm credits to a minimum. Depositor confidence is directly related to the problems of agriculture, and as problems in the rural sector increase the unrest and uneasiness continue to build.

It is impossible to say whether regulators could have or should have spotted agricultural lending problems earlier. For years the business of lending to our food producers had been premised, for the most part, on the borrower's net worth. Bankers realized all along that "cash flow" was relevant to the process and began to impose this requirement on their borrowers as an additional element in analyzing a loan application. Regrettably, however, not enough did so. The industry and regulators shifted their emphasis a few years ago to focus more on cash flow analyses. It had a positive impact in reducing the number of problem institutions today. But the decline in land

values and other collateral has been precipitous in farm areas. Farmers have seen their assets evaporate in terms of value almost overnight, and it has shown up when bank loans are evaluated.

Improving the Quality of State Regulation

In the near term, state regulators have played a variety of roles in handling the agriculture debt problem. They have increased the level of communication with bank management so as to resolve developing problems as early as possible. They have worked with federal agencies, PCAs, land banks and agriculture associations so as to coordinate efforts of all groups. In some cases they have helped develop the information by which the problem could be measured.

Of great importance to these efforts has been the regulator's emphasis on maintaining the quality of state banking departments. The Agricultural credit problem underscores the need for competently staffed and well-run safety and soundness oriented regulatory programs.

Increased examiner skills are necessary to ensure a prepared and timely response to developments such as the agricultural credit problem. State bank regulators and their federal counterparts are constantly improving the expertise of their staffs. One source of training is illustrated in the attached table. CSBS schools are designed to train: 1) beginning examiners; 2) examiners with developing skills with an emphasis on credit evaluation; 3) examiners with overall responsibility for bank examinations; 4) senior personnel who manage the bank regulatory

program; and 5) individuals with a need for specialized regulatory training, e.g. EDP auditing, legal affairs.

CSBS training responsibilities have grown from four training programs enrolling 283 examiners in 1978 to 21 programs which will train over 820 examiners in 1985.

As large an effort as the CSBS schools represents, it is only part of the state training story. State departments arrange for training from other sources, including:

- state universities, especially ag lending programs
- cooperative seminars in conjunction with the FDIC, FFIEC and the FRB
- self-developed programs using staff expertise

In addition to these training programs, the overall quality of the supervision of both troubled and nontroubled state-chartered institutions is being strengthened by CSBS Department Self-Evaluation and State Banking Department Accreditation programs--designed to help state regulators meet their own, diverse professional and managerial needs. The goals of these programs are to assure the safety and soundness of banking within each respective state.

The Self-Evaluation Program is part of a longstanding effort by state bank supervisors to take a critical look at themselves, to assess strengths and weaknesses and to make changes in operations, where appropriate.

The approximately 100 criteria of the CSBS-developed Self-Evaluation Guide provide a department with a list of those

items that other state regulators consider essential in maintaining a superior department. As such, the Self-Evaluation Guide is a multi-purpose tool that can be used by:

- state banking departments to self-improve.
- state banking departments to document needs for support and resources from their respective states.
- newly appointed state bank supervisors to "inventory" department capabilities and needs.
- state banking departments to determine if ready for accreditation review.

CSBS has developed a voluntary, formal Accreditation Program for State Banking Departments. The stated goals of the program, in addition to department self-improvement, are to:

- "demonstrate to and obtain from state administrations and legislatures the support and resources needed to achieve banking department capabilities necessary to assure safety and soundness of state banks and banking and to assure the determination by each state of its financial and economic destiny."
- "achieve recognition in the United State Congress, in federal agencies and within each respective state of the high level of capability of each accredited state banking department."

Such programs have not been driven by the agricultural lending situation. They are part of a longstanding commitment to the ongoing improvement of state agencies.

The existence of education and improvement programs does not solve the agricultural lending problem or any other problem based on exogenous factors. But such programs do allow regulators to play their proper role when a problem like this one arises.

The role of the regulator is to ensure laws and regulations as to safety and soundness are carried out, in the interest of the public who have a right to a stable and sound financial system. In addition, the regulator can enforce prohitions of conflict of interest and concentration of credits and loans so that credit is available to a broad cross section of the community on a nondiscriminatory basis. Within that context, we will do everything we can.

In short, the regulatory agency has its place, but it also has its limits. Macroeconomic variables cannot be overcome by regulatory fiat. We can and will work with federal and state agencies to identify problems and use our resources to ameliorate resultant harms. Such a role is more than a palliative, but is not a cure.

In the context of today's hearing a few comments about the state role, as the primary regulator of state-chartered institutions, are in order.

First, the chartering authorities have a broad interest in the safety, soundness and integrity of the financial institutions of the communities in their states.

Second, state supervisory knowledge of the community is a valuable resource, and combined with the broad responsibili-

ties of the primary regulator, this knowledge can help state regulators play an important role in legislatively-designed solutions.

Third, the quality of state bank regulation is high and bank regulators are striving to improve both people and procedures.

Fourth, suggestions as to regulatory restructuring which would lead to an increased ability on the part of federal agencies to focus their attention on problem areas are meritorious.

Two Possible Solutions to the Agriculture Credit Problem

Clearly, Mr. Chairman, a program which infused large amounts of capital by means of grants, loans or purchases of existing agricultural loans would help insure the survival of many agriculture banks. Such a program, coupled with changes in the fundamental factors which caused this problem, could be an effective solution. Given budget realities, such programs are unlikely to be signed into law.

If a direct infusion of cash is impossible, policy options become increasingly complicated. For noncash programs a careful weighing of short-term benefits and long run costs is necessary.

Net Worth Certificates have been suggested as one possible noncash solution. Under such a program, net worth certificates would be issued by the FDIC to agricultural banks whose capital has fallen below capital requirements. In the short run, such a tool would be of trememdous importance in helping maintain a sufficient level of confidence in our system. It would allow us

the time we need to help our banks and other financial institutions gain some breathing room. Most significantly, it would enable us to either legitimately delay or avoid having to close some of the weakened commercial banks. Because such a program is now in place for thrifts, another short run advantage is the reduced time this program would take to initiate.

Against this must be weighed the long term consideration that net worth certificates do not solve any fundamental problem. They only buy time. If farm conditions do not improve, business practices do not change and private capitalization of the troubled banks do not increase, the time bought by the certificates may, in some cases, only exacerbate the problem. It was with this understanding that CSBS endorsed the concept of net worth certificates for thrifts in 1982, and it is how we cautiously approach the concept as applied to agricultural banks in 1985.

Summary and Conclusions

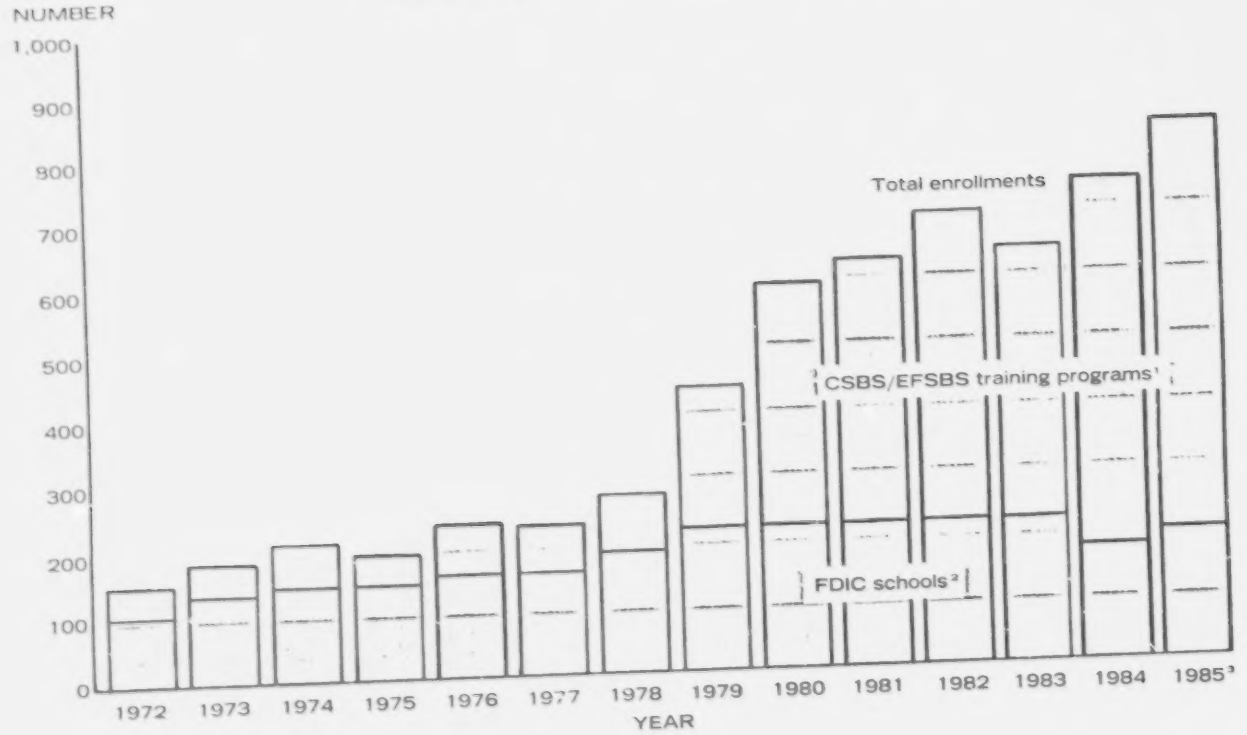
A large number of failures have occurred in banks with a concentration of loans related to agriculture. The effect of such failures has a direct bearing on communities throughout the country, reinforcing the macroeconomic problems which initially caused the failures.

In coping with this problem, state regulators contribute experience, responsibility and authority which can help to address some aspects of the problem and in some cases lessen the harm that follows a bank closing.

Unfortunately, however, in addressing a problem arising from nationwide economic factors, success of regulatory efforts depend on changes in those underlying factors.

Thank you, Mr. Chairman and members of the Committee.

CSBS-SUPPORTED EDUCATION AND TRAINING ENROLLMENTS, 1972-1985



[1] CSBS/EFSBS and states pay all costs.
[2] CSBS/EFSBS pays 40%, states pay 20% and FDIC pays 40% of total costs.
[3] Projected for 1985. First year of EFSBS operations.

press release

For further information contact
JOSEPH E. JONES, Vice President/Director of Public Affairs

Released For P.M.s
Friday, April 25, 1985

REGULATORS CAN PLAY IMPORTANT BUT LIMITED ROLE
IN ADDRESSING FARM CREDIT PROBLEM, CSBS STATES

Washington, D.C., April 26--The bank regulatory agencies have important but limited public interest roles in helping to ameliorate the harmful effects of recent agricultural bank failures, the Conference of State Bank Supervisors (CSBS) testified here today during hearings on the agricultural credit problem, the role of bank regulation and possible measures to correct the problem.

Testifying before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing and Consumer Affairs, Walter C. Madsen, Superintendent of Banks of Arizona, noted that in coping with the farm credit problem "state regulators contribute experience, responsibility and authority which can help to address some aspects of the problem and in some cases lessen the harm that follows a bank closing." He emphasized, however, that the regulators could do little to combat the root causes of the problem. "Questions of farm policy, international trade and monetary policy are beyond the scope of state bank regulators, the FDIC and the OCC," he stated, adding: "Macroeconomic variables cannot be overcome by regulatory fiat."

Madsen, who was recently elected chairman and president of the Conference, suggested four primary causes for the high incidence of agricultural bank failures. First, crop production and prices have been insufficient to generate revenues adequate to make timely repayments of debt. Second, marketability of crops has been adversely affected by the strength of the dollar. Third, persistantly high interest rates reflecting a successful fight against inflation by monetary authorities have affected all capital-intensive industries, farming included. Fourth, the increase in land values that occurred in the 1970s proved unsustainable.

Turning to the role of the state bank regulator in dealing with the agricultural debt problem, Madsen noted that "they have increased the level of communication with bank management so as to resolve developing problems as early as possible. They have worked with federal agencies, PCAs, land banks and agriculture associations so as to coordinate efforts of all groups. In some cases they have helped develop the information by which the problem could be measured."

In analyzing federal legislative solutions to the problem, Madsen noted that a direct capital infusion program was unlikely to receive sufficient support given budget realities. As an alternative, he voiced qualified support for a net worth certificate guarantee program provided its limitations were kept clearly in mind. "In the short run," he said, "such a tool would be of tremendous importance in helping maintain a sufficient level of confidence in our system. It would allow us the time we need to help our banks and other financial institutions gain some breathing room. Most significantly, it would enable us to either legitimately delay or avoid having to close some of the weakened commercial banks." But he emphasized that such an approach would "not solve any fundamental problem. They only buy time. If farm conditions do not improve, business practices do not change and private capitalization of the troubled banks does not increase, the time bought by the certificates may, in some cases, only exacerbate the problem."

# # # # # #

Senator DODD. Thank you, very much, Mr. Madsen; I appreciate your testimony.

Mr. Meadows, I'm delighted to hear from you as well and I'd ask, if you could, to summarize your statement. But we will accept, obviously, your prepared statement in its full text for the committee record.

STATEMENT OF A. DAVID MEADOWS, ASSOCIATE DIRECTOR, DIVISION OF BANK SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. MEADOWS. Thank you, Mr. Chairman.

My name is A. David Meadows. I am the Associate Director of the Division of Bank Supervision at the Federal Deposit Insurance Corporation.

We welcome the opportunity to present the FDIC's views on issues relating to the current farm situation and the impact of that situation on the banking industry and the implications for bank supervision and regulation.

PROBLEMS BEGAN IN 1981

The problems with agricultural banks began in 1981 and 1982 and became increasingly noticeable in the banks in mid-1984. And we believe that they will continue to grow until the conditions in the agricultural economy show improvement. Still, the problems in the banks are manageable, although they could be disruptive in the communities where failures occur.

As you can see from my complete statement, the number of problem agricultural banks has escalated dramatically. We closely supervise agricultural problem banks just as we supervise other problem banks.

In carrying out our examination responsibilities, we believe it is imperative that we make realistic appraisals of the condition of these banks. We would point out, however, that specific courses of action as to whether to curtail credit lines, restructure, forbear or foreclose, and when to do so and with respect to which borrowers, are bank management decisions that should be made with a view toward minimizing losses.

Our examiners are receptive to a showing by any bank management that they are working with their agricultural borrowers and doing all that can be done reasonably under the circumstances to run a safe and sound banking operation.

Most bankers have recognized and are dealing with their problems. Many are facing a challenge that they have never faced before as they are required to decide the best course of action for the borrower and the bank. Utilizing managerial skills and imagination, these bankers are striving to emerge from their problems as strong competitors willing and able to serve the credit needs of their communities.

The FDIC is both knowledgeable and appreciative of the agricultural difficulties. However, there is little we can, by ourselves, do to alleviate the problem. We will continue our policy of realistic and fair evaluation of farm banks and farm credits and participate in initiatives to aid in the recovery of the agricultural sector consistent with considerations of safety and soundness.

Further, we will strive to ensure that our staff continues to maintain its high level of professionalism. We do not, however, see significant improvement in the agricultural sector until reinvigoration of the agricultural economy occurs.

I'll be glad to answer any questions.

[The complete prepared statement follows:]

STATEMENT ON
FARM CREDIT PROBLEMS IN AGRICULTURAL BANKS
AND IMPLICATIONS FOR
BANK REGULATION

PRESENTED TO

COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND
CONSUMER AFFAIRS

BY

A. DAVID MEADOWS
ASSOCIATE DIRECTOR, DIVISION
OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.
Friday, April 26, 1985
Room SD-538 Dirksen Senate Office Building

Mr. Chairman, and members of the subcommittee, I appreciate the opportunity to discuss with you the problems being experienced by insured commercial banks engaged primarily in serving agricultural areas and the implications on regulation of these banks.

During the 1970s, in anticipation of continued export growth, increasing commodity prices and inflation in land values, many farmers, especially mid-size operators, borrowed heavily to expand operations. This higher debt was supported by using land values rather than by cash flow performance or prospects. Farm debt doubled from 1976 to 1981, the same period during which interest rates spiraled upward, which brought about higher debt servicing requirements. Also during this period petroleum prices were at high levels which contributed to increased production and operating costs.

Beginning in the 1980s, the anticipations of the 1970s failed to materialize. Exports dropped off and commodity prices declined or stagnated while interest and production costs were at high levels. Accordingly, land values declined and farmers who became reliant on rising values to finance their operations, now were forced to rely on generated cash flow which, for many, proved inadequate. Debt servicing, especially for the mid-size operator, became a significant problem.

Commercial banks provide less than 25% of total farm credit, the Cooperative Farm Credit System being the largest lender with just over 40% of farm

credit. There are about 4,100 agricultural banks in the country. An agricultural bank is defined as one in which agricultural loans comprise 25% or more of total loans. Of these, banks with agricultural loan-to-total loan ratios of 25 to 50 percent (roughly 2,375 banks) hold about $14.5 billion in agricultural loans. The banks are typically small, with average assets of about $32 million. Banks with agricultural loan-to-total loan ratios greater than 50 percent represent a little over 12 percent of all commercial banks (about 1,775 banks) and hold about 24 percent of the total volume of farm loans held by all commercial banks (or about $12.5 billion). Again, these banks are typically small, having an average asset size of just over $20 million.

In more general terms, the potential exposure of commercial banks to continued agricultural problems seems small when comparing the volume of assets of banks which are more highly concentrated in agricultural loans to those less concentrated. For example, banks with agricultural loan-to-total loan ratios of less than 10 percent hold nearly 89 percent of all domestic bank assets, while banks with agricultural ratios greater than 25 percent hold only a little less than 6 percent of all such assets. Nevertheless, the absolute volume of assets involved in banks which are more agriculturally oriented is not inconsequential. Assets at agricultural banks total about $114 billion. Furthermore, a significant number of banks with farm loan ratios between 10 and 25 percent may well have substantial amounts of loans that are not designated as farm loans, but which are directly or indirectly tied to the

health of the agricultural economy. A further complicating factor is the geographic concentration of farm loans among commercial banks.

Over 80% of the agricultural banks in the country are concentrated in 16 midwest and plains states. Agricultural banks comprise 45% of the 7,400 banks in the 16-state area. The banks in this area have loans totaling $21 billion or 41% of farm credit advanced by all banks. The majority of these institutions are state chartered banks not members of the Federal Reserve System which are jointly supervised by the states and FDIC. Needless to say, the supervision of these banks over the years has allowed the FDIC to amass considerable experience and expertise in evaluating agricultural banks and credits under both favorable and unfavorable economic circumstances.

Financial stress in the agricultural sector has contributed to deterioration in bank agricultural loan portfolios and impacted bank performance. During much of the 1970s, agricultural banks typically outperformed their non-agricultural counterparts. Return on assets was generally higher while the loan loss rate was consistently lower. With increasing pressure on agricultural banks because of problems in agriculture, their performance has been diminishing. This was especially exhibited during the last quarter of 1984.

Loan loss rates for agricultural banks in the 16-state area increased from 0.3% in 1980 to 1.4% in 1984 versus 0.4% and 0.7%, respectively for non-agricultural banks in the area. Non-performing loan data is not available prior to 1982; however, from 1982 through 1984 the non-performing loan rate

for the agricultural banks increased from 2.4% to 3.7% contrasted to the non-agricultural banks which maintained a rate of around 2.8% for this period. Accordingly, earnings have been impacted in the agricultural banks with return on assets declining from 1.4% in 1980 to 0.7% in 1984. The non-agricultural banks, on the other hand, held between a 0.9% and 1.0% return over this period. The net interest margin for the agricultural banks, however, remained comparable to the non-agricultural banks from 1980 through 1984, hovering around 5%, indicating that the former, in spite of loan problems, have been able to maintain sufficient yields on their assets. Whether or not this situation will continue if agricultural credits deteriorate further is uncertain.

Capital ratios for the agricultural banks reflect a modest increase from 1980 through 1984 and continue to be relatively strong. For this period capital ratios for agricultural banks increased from 9.3% to 9.8% and remained generally a full percentage above non-agricultural banks. It should be noted however, that in apparent anticipation of further loan losses, agricultural banks, during this period, have substantially increased loan loss reserves, which comprises a component of capital. All but 600 agricultural banks in the 16-state area continued to pay dividends through 1984, some without apparent supportive earnings positions. For 1984, 337 banks paid dividends greater in amount than net income, and 234 paid dividends while reporting net losses.

A review of some recent FDIC supervisory statistics may serve to enhance the perspective on agricultural banks. There were, as of April 12, a total of 931 problem banks of which 315, or 34%, were agricultural banks. This represents

a proportional increase over 1983 when agricultural banks were 20-24% of the total number of problem banks. 282 of the problem agricultural banks are located in the 16-state area where most of the nation's agricultural banks are situated. These banks comprise 56% of the 506 problem banks in that area.

By closely supervising agricultural problem banks, as other problem banks, the FDIC can provide a sound appraisal of credits and recommendations to management as the possible general courses of action. Specific courses of action as to whether to curtail credit lines, restructure, forebear or foreclose, and when to do so, and with respect to which borrowers, are bank management decisions that should be made with a view toward minimizing losses. Certainly we are receptive to a showing by any bank management that they are working with their agricultural borrowers and doing all that can be done reasonably under the circumstances to run a safe and sound banking operation.

When banks present warning signs of problems or are in danger of insolvency, the FDIC responds according to the severity of the situation, whether the problem stems from agricultural credits, real estate credits, energy credits or otherwise. We increase the number and frequency of examinations or visitations, and off-site reviews and surveillance become more intensive. Formal or informal administrative actions may be initiated as necessary. If efforts to turn the situation around are not successful and the chartering authority closes the bank, the FDIC may be then forced into its role as receiver and try to arrange a purchase and assumption, or if necessary, pay off depositors.

As of April 12, 1985, outstanding formal enforcement actions by the FDIC against banks in the 16-state area numbered 197 compared to 453 against banks nationwide. They are broken down as follows: 20 termination of insurance actions under Section 8(a); 146 cease and desist actions under Section 8(b); and 3 temporary cease and desist actions under Section 8(c); and 28 suspension and removal actions under Section 8(e); and (g). Cease and desist orders are outstanding against only 149 of a total of 322 area state nonmember problem banks, indicating the FDIC, in conjunction with state authorities, is able to effectively deal with problem situations outside its formal administrative action process.

The trend of assets classified at examinations of the agricultural banks reflects a substantial increase from 22% of capital in 1980 to 50.7% in 1983, then declining to 44.5% in 1984. This decline is not necessarily cause for comfort because a number of banks not examined since January 1984 and until now not considered of supervisory concern, appear to have experienced deterioration according to recent offsite reviews. Scheduled follow-up examinations may reflect increased classifications in these institutions. Of note is that classifications at examinations of non-agricultural banks reflect a greater increase over the same period, from 27.9% of capital in 1980 to 74% in 1983 then also declining somewhat in 1984. Worthwhile mentioning in this regard is that in a recently conducted agricultural bank survey by the American Bankers Association (ABA), 88% of the respondents indicated no major disparity between their banks' agricultural problem loan list and the findings of examiners.

Failed bank statistics provide further perspective on the agricultural bank situation. There was a substantial increase in the number of bank failures in the 16-state area, from 14 in 1982 to 39 in 1984, and this upward trend appears to be continuing in 1985. Through April 12, 15 bank failures have occurred in this area, well over half of the 25 failures nationwide. Agricultural bank failures nationwide increased from 9 in 1982 to 25 in 1984 with 16 in 1985. During the period from January 1, 1984 to February 5, 1985 the FDIC expended around $280 million to facilitate failed agricultural bank transactions. This cash infusion then became available as a funding source for worthy agriculture borrowers.

An FDIC study of agricultural bank failures that occurred between January 1, 1984 and February 5, 1985 indicates that none was solely due to adverse economic conditions. Although a depressed agricultural economy perhaps accelerated the failures, the primary cause in many instances was mismanagement coupled in some cases, with insider abuse.

It is unlikely credit problems in agricultural banks will lessen in 1985, or possibly even 1986. The aforementioned ABA survey evidenced that more of these banks' farm borrowers are experiencing financial stress, and, that there was little hope for any improvement in bank loan portfolios, at least through mid-1985. Agricultural banks will likely face continued higher proportions of delinquent loans and loans on which accrual of interest has been discontinued due to their quality. Further, there is a sizeable number of highly leveraged borrowers. According to the 1985 Agricultural and Credit Outlook of the Farm Credit System, nearly 61% of commercial banks' farm borrowers have a debt-to-

asset ratio greater than 40%, and somewhat more than one-half of these borrowers exceeded 60%. This situation will warrant continued close bank supervision by regulators and, probably, more conservative lending practices in banks servicing the agricultural sector.

The FDIC is both knowledgable and appreciative of the agricultural difficulties; however, there is little we can, by ourselves, do to alleviate the agricultural credit problem. We will continue our policy of realistic and fair evaluations of farm banks and farm credits, and, participate in initiatives to aid in the recovery of the agricultural sector consistent with considerations of safety and soundness.

Policy directives have been issued by the FDIC to its examiners during the past two years reinforcing the importance of realistic, objective and fair analysis and appraisal of agricultural credits and banks holding those credits. In addition, FDIC management has met with examiners on a frequent basis to discuss agricultural credit issues. Our personnel from senior management through senior staff levels have also met with various groups representing both banking and agriculture, on a national, regional and local basis, in an effort to exchange information and viewpoints and thereby attain greater mutual understanding.

The FDIC has made a special effort to offer assistance to states where agricultural problems are prominent. For example, we have provided technical assistance and personnel to Iowa and Nebraska in handling certain failed financial institutions even though they were not covered by federal deposit

insurance. Also, we have expedited the processing of applications for deposit insurance for new banks and existing non-insured banks from within these states so that necessary adequate banking facilities could be afforded smaller communities.

The FDIC will continue its conscious efforts to exercise its responsibilities in face of banking problems related not only to agriculture but other sectors of the economy. We will continue to investigate ways that will increase our effectiveness in dealing with these while striving to maintain confidence in the banking system and the deposit insurance fund.

Attached are schedules listing the 16 midwest and plains states containing the majority of the nations agricultural banks and showing performance characteristics and supervisory statistics for agricultural and non-agricultural banks in this area.

TABLE 1

Sixteen Midwest and Plains States
Data as of 12/31/84

	Agricultural Banks (000,000 Omitted)		
	Number	Total Deposits	Agricultural Loans
Colorado	70	1,758	558
Idaho	12	754	226
Illinois	412	10.119	2,195
Indiana	93	3,550	730
Iowa	529	14,100	3,843
Kansas	417	7,547	2,243
Michigan	22	851	178
Minnesota	389	7,327	2,126
Missouri	288	6,331	1,483
Montana	74	2,113	470
Nebraska	396	8,009	2,924
North Dakota	136	3,123	844
Oklahoma	156	3,708	811
South Dakota	127	5,189	1,451
Wisconsin	191	4,121	1,026
Wyoming	25	743	161
Total	3,337	79,433	21,269
Percentage of all Agricultural	84%	80%	83%

TABLE 2

AGRICULTURAL BANKS - PERFORMANCE CHARACTERISTICS

Agricultural Banks - 16 Midwestern and Plains States
Performance Characteristics

	1980	1981	1982	1983	1984
Non performing	-	-	2.4	2.8	3.7
Capital Ratio	9.3	9.4	9.5	9.7	9.8
Loans/Assets	56.4	53.0	51.7	51.0	52.1
Returns on Assets	1.4	1.4	1.3	1.1	0.7
Net Interest Margin	5.2	5.4	5.3	5.2	4.9
Net Loan Losses/Loans	0.3	0.4	0.7	1.0	1.4

Non Agricultural Banks - 16 Midwestern and Plains States
Performance Characteristics

	1980	1981	1982	1983	1984
Non performing	-	-	2.8	2.7	2.8
Capital Ratio	8.6	8.5	8.4	8.3	8.4
Loan/Assets	57.2	54.9	53.7	52.6	54.3
Return on Assets	1.0	1.0	0.9	0.9	0.9
Net Interest Margin	5.2	5.3	5.3	5.2	5.1
Net Loan Losses/Loans	0.4	0.4	0.7	0.3	0.7

TABLE 3

PROBLEM BANKS

	Number of Problem Banks				
	1983	1984	To Date 4/12/85		
			Total	Agricultural	Other
16 Midewest and Plains States	293	445	506	282	224
34 Other States, D.C. and Puerto Rico	307	355	425	33	392
Total	600	800	931	315	616
Subtotal - 16 Midwest and Plains States as % of Total Problem Banks	49%	56%	54%		
1985 - Agricultural Banks as % of Total Problem Banks	34%				

TABLE 4

AGRICULTURAL BANK FAILURES

	1982	1983	1984	To Date 4/12/85
Number of bank failures in 16 midwest and plains states	14	15	39	15
Other states	28	33	40	10
Total Bank Failures	42	48	79	25
Number of Agricultural Bank Failures	9	11	25	16
Banks in 16-state area as a percentage of total bank failures	33%	32%	50%	60%
Agricultural Bank failures as a percentage of total bank failures	21%	23%	32%	64%

Senator DODD. Thank you very much.
Mr. Downey.

THE STATEMENT OF JOHN F. DOWNEY, CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DOWNEY. Thank you, Mr. Chairman.

My name is John Downey. I'm the Chief National Bank Examiner, Office of the Comptroller of the Currency.

14,400 commercial banks hold about $50 billion in farm loans. That's less than one-fourth of the total farm debt, or less than half of this amount, or $24½ billion is held by 4,000 agricultural banks.

We consider agricultural banks to be those with farm loans exceeding 25 percent of their loan portfolios. The financial performance of each of these banks mirrors its local economy.

The typical agricultural bank is small with average assets of $27 million compared to $199 million for nonagricultural banks. And 84 percent of the agricultural banks in this country have been in existence for 50 years or more. Only 52 percent are nonagricultural banks to make that claim.

Over the years, agricultural banks have enjoyed a very favorable return on assets when compared to nonagricultural banks. Accordingly, the average agricultural bank is generally more highly capitalized than a nonagricultural bank. The ratio for primary capital compared to assets is more than 10 percent for our agricultural banks and a little less than 9 for nonagricultural banks.

Also, 73 percent of the agricultural banks in this country have no branches and operate out of one location. State law prohibits the majority of these institutions from branching.

DIVERSIFICATION BLOCKED BY STATE LAW

With traditional averages for diversification blocked by State law, the typical agricultural bank has few alternatives. Most depend heavily on a particular crop that is grown locally. Other alternatives for diversification or expansion can present great risk; making out-of-area service loans and getting involved in sophisticated securities activities with out-of-area brokerage firms.

The current situation faced by most agricultural banks can be illustrated by looking at banks in the Midwest, a seven-State area including Iowa, Kansas, Nebraska, Minnesota, Missouri, and the Dakotas. From 1979 through 1984 net income from these banks declined from $485 to $362 million, a 25-percent drop. This earning decline is a direct byproduct of loan loss problems within the agricultural sector.

It is interesting to note, however, despite the widely publicized problems in agricultural banks, dividends paid to shareholders by these banks virtually doubled during this period, from $122 to $238 million. Clearly, many agricultural banks feel sufficiently healthy to use previously accumulated capital to pay dividends.

During the past year, numerous proposals have been made to assist farm borrowers and lenders. Among these are proposals that would require bank regulators to substantially change and not apply longstanding bank supervisory policy.

In addressing these proposals, we have reiterated our belief that the fundamental economic problems of the agricultural sector are not due to commercial bank problems and cannot be resolved by changes in bank supervisory policy.

The primary purpose of bank supervision is to preserve the safety and soundness of the banking system. To achieve that goal we must be sure that the depositors are protected. To assure institutional soundness, we examine loan portfolios and classify loans where it appears they will not be paid in part or in total.

In evaluating problem loans, examiners consistently apply standards in a cautious and prudent manner. The classification process is designed to identify the loans that will require careful management by the bank in order to be collected. The fact that a loan is classified does not change the financial capacity of the borrower.

Examiners have no interest in forcing foreclosures and have no desire to be unduly harsh in their criticism of loans. In fact, as previously mentioned, the ABA survey indicated 88 percent of the agricultural banks responding to their survey indicated there was no major disparity between their banks problem loan list and the findings of our bank examiners.

Notwithstanding, proposals continue to surface which would restrict and dictate the classification of credit by Federal bank regulators.

I would now like to turn for a couple of minutes to other proposals to provide assistance to commercial banks with large agricultural loan portfolios.

These proposals would offer help in the form of net worth certificates or changes in bank accounting practices, such as permitting capitalization of interest for troubled farm debt, carrying other real estate at inflated levels on the bank's books, and deferring known losses.

OPPOSED TO SHORT-TERM REMEDIES

My office is opposed to all of these short-term remedies that do not address the fundamental problem.

The Net Worth Certificate Program was instituted primarily to provide help for the thrift industry in its transition to an environment of deregulated interest rates and increased competition. Thrifts were experiencing operating losses because their costs were increasing while yields from their assets were not.

The low yield on the mortgage loans, not their quality, was at the heart of the problem. It was reasoned that, over time, the imbalance between cost and yields would disappear as low-yielding loans matured and the proceeds were reinvested at higher yielding interest rates.

The program was intended to restore thrifts to profitability by giving them time to restructure their loan portfolios and streamline their operations.

The situation for problem agricultural loans is different. Losses in many farm banks result from an inability of the farmer to repay the principal on their loans, and there is no reason to believe that the mere passage of time will correct this situation. Moreover, net worth certificates would provide no new funds that a bank could

use to loan to farmers. They would bail out the private stockholders without offering assistance to the farm borrower.

There have been other suggestions which I haven't got the time to go into. Capitalization of interest on problem loans is not the answer. Others have recommended that Federal regulators abandon the commonly accepted approach used in determining carrying values of other real estate.

These proposals would permit banks to carry assets on their books in amounts greatly in excess of their market value by either using prior year appraisals or applying a 5-year moving average for land values. In effect, banks would be allowed to avoid recognizing the reality of the marketplace in hopes that some unforeseen change might occur.

Finally, some have also suggested that banks be allowed to defer losses incurred from the sale of assets. In cases where the sale price is less than the carrying value on the bank's books, the institution would be allowed to create a nonexistent asset on its books. This practice is regarded by bank regulators to be unsafe and unsound.

In conclusion, I would just say agricultural banks in this country, although burdened with an increased number of problem loans, have the underpinning of a strong capital structure and stable deposit base. Therefore, the proposals to change prudent accounting standards and to provide Federal financial assistance to commercial banks are unwarranted and unnecessary.

Thank you.

[The complete prepared statement follows:]

STATEMENT OF

JOHN F. DOWNEY
CHIEF NATIONAL BANK EXAMINER
OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS SUBCOMMITTEE

Of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

April 26, 1985

Mr. Chairman, members of the subcommittee, I appreciate the opportunity to be here today to discuss farm credit. There are a number of important points that must be addressed. First, I would like to briefly review the causes of the problems facing farmers. Then I will discuss the effects of nonperforming agricultural loans on the commercial banks that provide operating credit to farmers. Finally, I will describe the approach that the Office of the Comptroller of the Currency (OCC) has followed in supervising these banks.

American agriculture is going through a difficult period. Farm export earnings and asset values have dropped precipitously since 1980. Many farmers are experiencing serious cash flow problems because they borrowed heavily during the 1970s to expand their operations. Some of these farmers have already failed.

Agricultural lenders have been directly affected by the problems of farm borrowers over the last few years. Both federal and private lenders have been hit by a dramatic increase in problem loans. Moreover, most experts suggest that the problems of supply and demand imbalances and declining farm asset values will persist for at least the next year. The key to solving the ag bank problem involves a healthier agricultural sector, not changes in bank supervisory policy, accounting rules, or federal assistance to financial institutions.

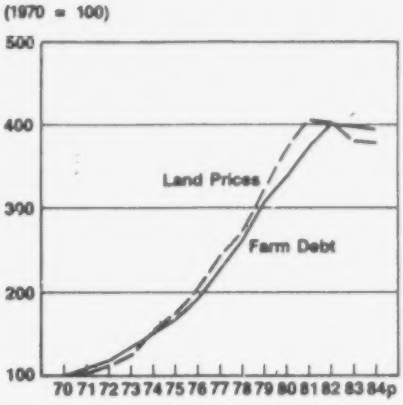
DESCRIPTION OF THE FARM PROBLEM

The agricultural sector has run into problems because many farmers adopted business strategies based on expectations of continued inflation, rising land values and strong export growth. In the 1970s farmers borrowed heavily to expand their operations. Most of these land purchases were financed by sources other than commercial banks. From 1976 to 1981, farm debt doubled. Although the bulk of this lending came from the Federal government and the farm credit system, commercial banks also increased their farm lending by 37 percent. This increased debt occurred at a time of rising interest rates that resulted in much higher debt servicing requirements. Although farmers

experienced only modest gains in cash flow, many could and did leverage their capital gains in farmland to develop additional acreage.

FARMERS BORROWED HEAVILY TO EXPAND

LURED BY RISING LAND PRICES

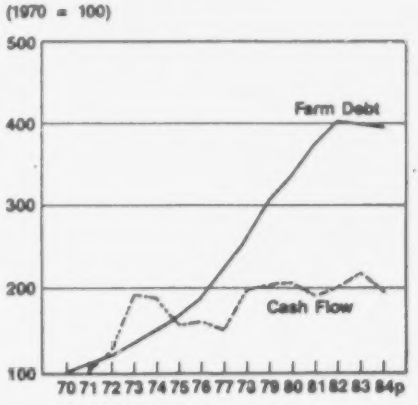


p = Preliminary

Farm debt excludes farm households

Source: Federal Reserve

AND IGNORING SLUGGISH GROWTH IN CASH FLOW



p = Preliminary

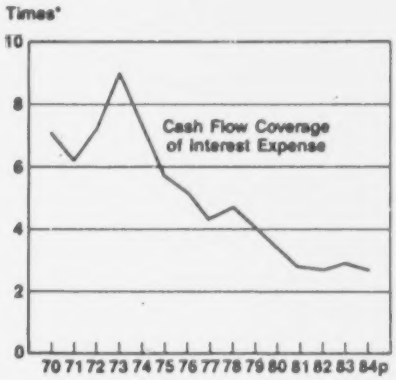
Cash flow after interest & taxes (Excluding farm households)

Source: USDA, Federal Reserve

Unfortunately, the expectations of these farmers were not met. First, the rapid inflation of the late 1970s was brought under control and dramatically reduced. Second, farm conditions deteriorated at the beginning of the 1980s due to a decline in exports, stagnant commodity prices, high interest rates, and increased production costs. As a result, land prices declined. Farmers who suffered the most were those who had mortgaged their future by speculating on rising land values. Many of the heavily leveraged farmers found themselves unable to meet higher debt service requirements because of inadequate cash flow.

FARM CREDIT QUALITY IS DETERIORATING

AS DEBT SERVICING CAPACITY HAS ERODED

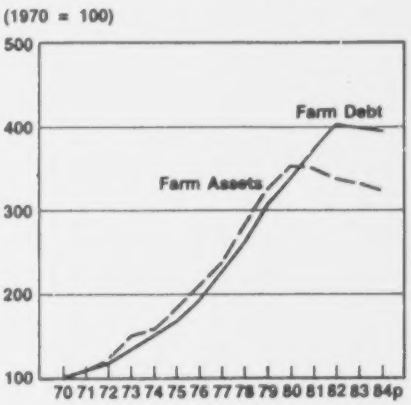


p = Preliminary

*Cash flow before interest/interest expense (Excluding farm households)

Source: USDA

AND COLLATERAL VALUES HAVE FALLEN



p = Preliminary

Farm debt & farm assets exclude farm households.

Source: Federal Reserve

The farm problem is national in scope, but it is especially severe in certain parts of the country. Financing problems and foreclosures are concentrated in the Midwestern and Central states and among farms producing export sensitive crops like corn, soybeans, cotton and wheat. In the fall of 1984, the Federal Reserve Bank of Kansas City conducted a survey of its district and found that one farm in ten was undergoing full or partial liquidation.

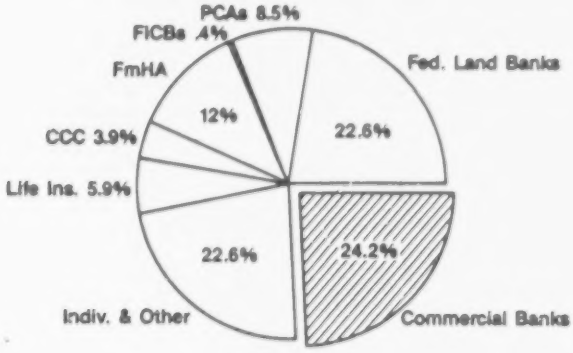
Farm problems also vary with the size of farm. In general, large farms continue to have adequate earnings and sufficient financial resources. Most owners of small farms have additional sources of outside income. The real problems are largely concentrated among mid-sized farms -- those with annual sales of $50,000 to $500,000.

Mid-sized farms constitute 30 percent of all farms, but they account for 64 percent of all farm debt. Many mid-sized farms have experienced several consecutive years of operating losses, and for them debt repayment is difficult. In fact, a recent USDA study estimates that 6.3 percent of mid-sized farms are already technically insolvent and another 7.4 percent are approaching insolvency. These 93,000 farms represent only four percent of all farms, but they hold over 20 percent of total farm debt.

AGRICULTURAL BANKS MIRROR THE CONDITION OF THE LOCAL ECONOMY

Farmers get loans from a variety of private and public sources, including commercial banks. Banks have traditionally played a very small role in lending for the purchase of farmland, but they do provide about 10 percent of all operating credit for farms. The 14,400 commercial banks hold about $50 billion in farm loans -- that's less than one-fourth of the total farm debt. A little less than half of this amount, or $24.9 billion, is held by 4,000 agricultural banks. We consider ag banks to be those with farm loans exceeding 25 percent of their loan portfolio. The assets of agricultural banks equal about 1.4 percent of the total $2.5 trillion in bank assets. Eighty-five percent of these banks are located in 13 states.

COMMERCIAL BANKS HOLD ABOUT A QUARTER OF OUTSTANDING FARM DEBT



($213 Billion)

Farm Debt Includes Farm Households

Source: Federal Reserve, December 1984, Preliminary Data

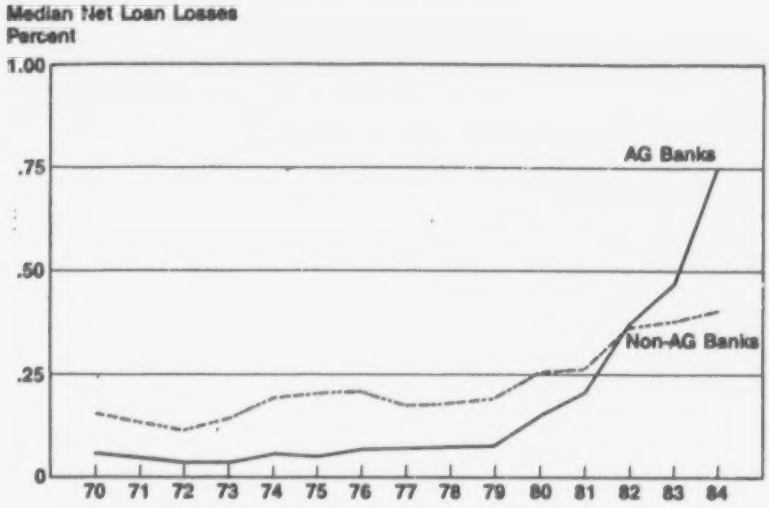
The financial performance of each of these banks mirrors its local economy. The typical ag bank is small, with average assets of only $27 million compared to $199 million for non-ag banks. Eighty-four percent of ag banks have been in existence for 50 years or more; only 52 percent of non-ag banks can make that claim. Over the years, ag banks have enjoyed a very favorable return on assets when compared to non-ag banks. Accordingly, the average ag bank is generally more highly capitalized than a non-ag bank. The ratio for primary capital compared to assets is more than 10 percent for ag banks and 9 percent for non-ag banks.

Seventy-three percent of ag banks have no branches and operate at only one location. State law prohibits the majority of these institutions from branching. With traditional avenues for diversification blocked by state law, the typical ag bank has few alternatives. Most depend heavily on a particular crop that is grown locally. Other alternatives for diversification or expansion can present great risk; they include solicitation of brokered deposits, making out-of-service area loans, and getting involved in sophisticated securities activities with out-of-area brokerage firms.

The condition of individual ag banks reflects the financial distress of their local farm communities. In a survey conducted by the American Bankers Association (ABA) in January 1985, ag banks reported that 41 percent of their farm borrowers had a negative net farm income in 1984. In the same survey, ag banks estimated that 37 percent of their borrowers would have a negative net farm income again this year.

The increasing number of problem farm loans is cutting into bank earnings. In December 1984, 522 ag banks reported losses, up from 282 in December 1983. These banks are obligated to pay interest on their deposits, even when they do not receive interest payments on some of their loans. Ag banks with large portfolios of nonperforming loans clearly are caught in an earnings squeeze.

NET LOAN LOSSES OF AG BANKS HAVE RISEN SHARPLY SINCE 1979



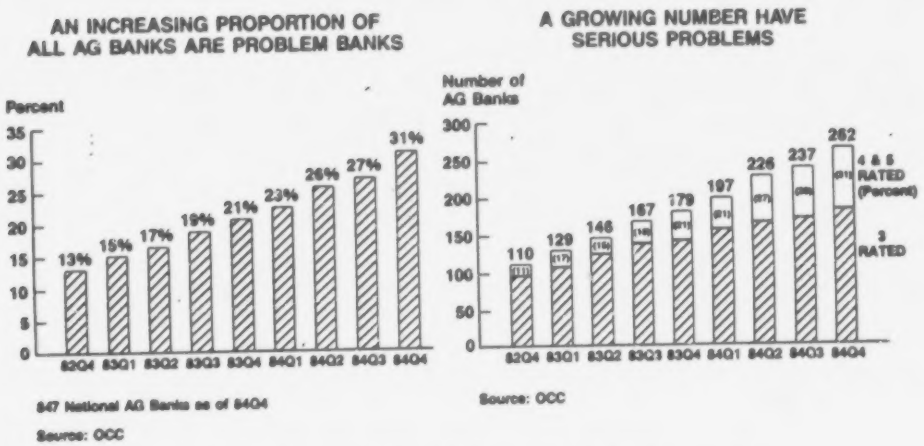
Insured Commercial Banks with Assets Under $100MM
Source: Call Reports

The OCC is closely monitoring the condition of national ag banks. According to information from our recent examinations, on average, classified loans at these national ag banks are now almost equal to their capital funds. Moreover, the number of national ag banks that have been placed on our watch list because of poor performance has doubled since December 1982. About one third (31 percent) of federally chartered ag banks are now considered banks requiring special supervision (i.e., have a CAMEL rating of 3, 4, or 5). In many cases performance has been

bad bank management. In some cases, however, the primary cause of poor performance can be traced to nonperforming agricultural loans. We believe that such problems are likely to continue to trouble ag banks over the next few years.

THE CONDITION OF AG BANKS IS DETERIORATING

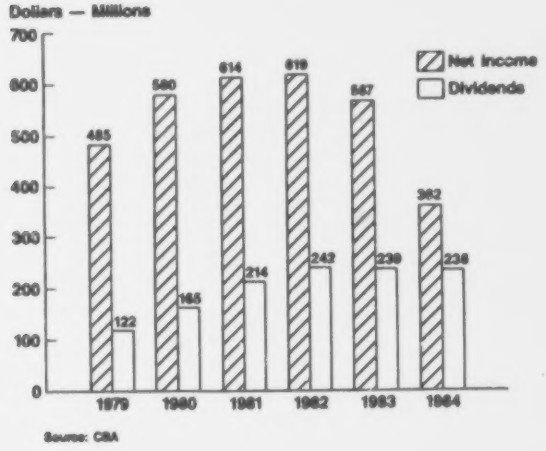
(National Banks Rated 3, 4, and 5)



The current situation faced by most ag banks can be illustrated by looking at banks in the Midwest. From 1979 through 1984, net income for these banks declined from $485 million to $362 million, a 25 percent drop. This earnings decline is a direct by-product of the loan loss problems within the agricultural sector. Provisions for loan losses at Midwestern ag banks nearly doubled during 1984 to $589 million.

Actual loan losses for 1984 were $490 million versus $261 million in 1983.

TREND OF NET INCOME AND DIVIDENDS
ALL MIDWESTERN AG BANKS



It is interesting to note that, despite the widely publicized problems in agricultural banks, dividends paid by these banks virtually doubled between 1979 and 1984, from $122 million to $238 million. Clearly, many ag banks feel sufficiently healthy to use previously accumulated capital to pay dividends.

Despite the fact that primary capital for Midwestern ag banks declined 40 basis points in the last quarter of 1984, primary capital remains in excess of 10 percent, If fourth

quarter loan losses ($235 million, in addition to a total loss of $255 million for the previous three quarters) are any indication of future events, these capital levels will be strained. However, we believe the majority of ag banks will survive, recover and prosper.

THE RESPONSE OF BANK SUPERVISION

During the past year, numerous proposals have been made to assist farm borrowers and lenders. Among these are proposals that would require bank regulators to substantially change or not apply long-standing bank supervision policy. In addressing these proposals we have reiterated our belief that the fundamental economic problems of the agricultural sector are not due to commercial bank problems and cannot be resolved by changes in bank supervision policy . The primary purpose of bank supervision is to preserve the safety and soundness of the banking system. To achieve that goal, we must be sure that depositors are protected. To assure institutional soundness, we examine loan portfolios and classify loans when it appears they will not be repaid in part or in total. But it is the banks, not the OCC, that decide who will receive a loan, how much to lend, what collateral will be required and how much time should be allowed for repayment.

Bank examiners classify assets based on their prospects for timely repayment. Classifications include substandard, doubtful, and loss. To analyze these credits, examiners evaluate the source of repayment, the adequacy of collateral, and the ability of the borrower to repay the loan. These same factors are applied to all loans regardless of whether they are extended to agricultural, energy, real estate, or any other commercial entity.

In evaluating problem loans, examiners consistently apply standards in a cautious and prudent manner. The classification process is designed to identify the loans that will require careful management by the bank in order to be collected. The fact that a loan is classified does not change the financial capacity of the borrower. Examiners have no interest in forcing foreclosures and have no desire to be unduly harsh in their criticism of loans. In fact, in the same ABA survey that I mentioned earlier, 88 percent of the ag banks said there was no major disparity between their bank's problem agricultural loans and the findings of bank examiners.

Banks should not interpret classification of a credit by an examiner as a request for foreclosure. On the contrary, the OCC encourages banks to develop sound workout plans on all problem loans and joined other regulatory agencies in issuing a joint

statement reinforcing our long-standing policy of encouraging banks to work with farmers who are experiencing temporary problems. The statement is attached to this testimony.

The only time that the OCC will ask a bank to take a particular loan off its books is when the loan is considered uncollectible and is classified as a loss. Even in those circumstances, bank management -- not the OCC -- decides what action, if any, to take to achieve recovery.

In response to the problems of ag banks, the OCC has taken numerous steps to ensure that our policies and the imlementation of those policies are consistent with the problems facing agricultural banks. The OCC provided guidance and special training to examiners to assure that standards are applied consistently throughout the country.

We are monitoring the performance of the farm sector and have participated in seminars with ag banks. Both district and Washington staff have analysed data on farm problems. This information is sent to our field examiners on a regular basis.

The OCC is also an active participant in the interagency task force on ag problems chaired by Secretary Block of the Department of Agriculture. This group has been working on programs to deal with the ag credit crisis in conjunction with the Administration's initiatives.

OTHER PROPOSED REMEDIES

I would now like to turn to other proposals to provide assistance to commercial banks with large agricultural loan portfolios. These proposals would offer help in the form of net worth certificates and/or changes in bank accounting practices, such as permitting capitalization of interest for troubled farm debt, carrying other real estate at inflated levels on banks' books, and deferring known losses. The OCC is opposed to all of these short-term remedies that do not address the fundamental problem.

The net worth certificate program was instituted primarily to provide help to the thrift industry in its transition to an environment of deregulated interest rates and increased competition. Thrifts were experiencing operating losses because their costs were increasing while yields from their assets (primarily low, fixed rate mortgage loans) were not. The low yield on the mortgage loans, not their quality, was at the heart of the problem. It was reasoned that, over time, the imbalance between costs and yields would disappear as low-yielding loans matured and the proceeds were reinvested at higher interest rates. The program was intended to restore thrifts to profitability by giving them time to restructure their loan portfolios and streamline their operations.

The situation for problem agricultural loans is entirely different. Losses in many farm banks result from an inability of farmers to repay the principal on their loans, and there is no reason to believe that the mere passage of time will correct the situation. Moreover, net worth certificates would provide no new funds that a bank could use to make loans to farmers. They would bail out private bank stockholders, without offering assistance to farm borrowers.

Another suggestion for alleviating the problems of agricultural borrowers concerns the capitalization of interest. Capitalized interest is generally defined as uncollected interest that is added to unpaid principal. In effect, loans are rolled over at maturity with the uncollected interest included in the new loan.

The Comptroller's Office believes that capitalization of interest is appropriate only when the lender judges that a borrower has the ability to repay the debt in the normal course of business. Clearly this is not the case for many troubled borrowers. The continued recording of unpaid interest as income inflates both the assets and the earnings of a bank and misleads shareholders and the general public.

Lenders must ask themselves a number of questions concerning interest capitalization. Was interest capitalization anticipated when the loan was made? Is the loan well secured either by collateral or the guaranty of a financially responsible party? Is repayment of the loan based upon a reasonably ascertainable event in the future? Can the borrower obtain funds from sources other than the existing creditor at similar rates and terms? And finally, is there little or no doubt as to the ultimate collection of all principal and interest?

In short, there must be a reasonable expectation that the borrower's financial condition will improve with the passage of time. That expectation may be unfounded with a number of agricultural loans.

Others have recommended that federal regulators abandon the commonly accepted approach used in determining carrying values of other real estate. These proposals would permit banks to carry assets on their books at amounts greatly in excess of market values, by either using prior year appraisals or applying a five-year moving average for land values. In effect, banks would be allowed to avoid recognizing the reality of the marketplace in hopes that some unforeseen change might occur.

Finally, some have also suggested that banks be allowed to defer the losses inccurred on the sale of assets. In cases where the sales price is less than the carrying value on the bank's books, the institution would be allowed to create a nonexistent asset on its books. This practice is regarded by bank regulators as unsafe and unsound.

Failure to reflect the true value of assets or recognize known losses would seriously distort the bank's financial condition and income. This would further erode public confidence, on which our commercial banking system is predicated.

CONCLUSION

Changes in bank supervision or accounting will not address the fundamental problems in the agricultural sector and could cause some distortions in the banking system. Lenders, farmers, and regulators share a strong common interest in the long-term success of the farm economy. All of us recognize that problems in the agricultural sector of the economy will take several years to resolve. We believe the recently implemented debt adjustment program (DAP) will help a number of farm borrowers through the present crisis. The full effect of the program has

yet to be felt. In the meantime, the agricultural banks in this country, although burdened with an increased number of problem credits, have the underpinning of a strong capital structure and stable deposit base. Therefore, the proposals to change prudent accounting standards and to provide federal financial assistance to commercial banks are unwarranted and unnecessary.

* * *

Mr. Chairman, that concludes my prepared remarks. I will be happy to answer questions.

Senator DODD. Thank you very much, Mr. Downey, and I thank the panel.

Let me first of all tell you that obviously, as a member of this body from the State of Connecticut, we were a very strong and vibrant agricultural sector of the country, but that occurred sometime prior to my arrival in politics. But I must tell you as well, we do have our agricultural interests—our dairy farmers, tobacco, our broad-leaf tobacco, and so forth. But it is not a major, not a crucial issue. We are now a more service-oriented kind of a State.

But nonetheless, I happen to feel, as someone who is not from a farm State—and I think I share the views of many others who are not—that obviously what happens in our agricultural sector of this country has a profound impact on people in my home State, and I think there is a growing realization of that as well.

This notion that has persisted for some time that what happens in farm States had little or no impact on other sectors of the county has, I think, diminished significantly.

In fact, I noted with some interest I received a tremendous amount of mail from constituents in my home State over the recent crisis and the proposals that were made, ultimately vetoed by the President. But in the past one might have thought that was a dangerous vote to cast for a New England Senator, and yet I found my constituency, while they were concerned about how this was going to work and whether or not it made a lot of sense, they understood that the issue was important and that there was a role—or at least an effort should be made by the Government to help out in some way, which I find enlightening and encouraging. So I think that is a healthy step.

Mr. Downey, let me begin with you. Your statement sort of tells me what we can't do or what won't work. Aside from waiting this thing out and hoping that we get a handle on deficits and the value of the dollar diminishes and exports pick up, interest rates come down, which we would all like to see, you seem to be saying to me that there isn't a tremendous amount that we can do that is going to make anywhere near as profound an impact on the overall prob-

lem unless that occurs and that anything else we may be trying may be illusory. The net worth certificate you seem to have little faith in that it will actually solve many of the problems.

What would you suggest we do in the short run?

Mr. DOWNEY. I would just like to say, Senator, that I think the net worth certificates are an answer, but I don't think they are the right answer at this point in time.

RESTRUCTURING DEBT

What I tried to point out is there are problems. I think during the last year, in particular, the industries were working much closer with their members trying to work ways in which bankers can help the farm borrowers; first of all, by restructuring debt, sitting down and talking with the borrowers, trying to work their way out of this problem. I think an awful lot has been done in that area. The banking communities themselves have a lot to do before Government has to step in.

I mentioned State laws, for example. I think, liberalizing branching in some States would give diversification to a lot of these banks.

The banks I am looking at that have problems are very small, isolated banks that have no other game to play, and if they were a part of an entity and with a broader management base they would probably survive. When we talk about numbers of problem banks, they are really distorted sometimes; we are losing more banks than we ever have. They are small banks in a community. They are the most important thing in their community. I accept that.

Senator DODD. Well, you said 79 banks went under last year, 20 already in the first quarter. One of you pointed that out in your testimony.

How many banks have started up? How many new banks started in 1984?

Mr. DOWNEY. Well, the number of banks are increasing in the country, so I would say they are greatly offsetting. I don't have the exact figures, and as you know, there are an awful lot being held in abeyance, I guess until the nonbank bank issue is resolved. But the number of banks, commercial banks, in this country is increasing.

Senator DODD. I was just curious as to what would motivate someone to start an agricultural bank in the last couple of years, given the problems they have had.

Would any one of you care to respond to that at all? Are those numbers increasing?

Mr. MEADOWS. Senator, I don't have any information either, but I recall that most of the new banks are in States such as Texas, California, the so-called Sun Belt, and I don't recall that very many new banks have started in the 16-State area comprising most of the agricultural banks.

Senator DODD. By the way, Senator Sasser, from Tennessee, who is not a member of this subcommittee, wanted to be here today but couldn't come by. But he has a statement that we will include in the record if—there is no one here to object. It will be.

STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman. I want to commend you for holding these important hearings today on the condition of this country's agricultural banks. Much of the attention earlier this year was focussed, and rightly so, on the immediate crisis facing our farmers. It was a credit crisis, one that threatened the spring planting season. As much as those problems have been pushed from the front page, I will say with respect to the farmers in Tennessee that the crisis is far from past. I'm sure other members of the committee, indeed from throughout the Senate, are continuing to hear details from back home about the struggle—sometimes futile—to avoid bankruptcy.

And what happens when these farmers go under? The damage is not just to the farmer and his family, though that in itself is enough to warrant a congressional response, in view of the depth and breadth of the problem. It's not just the farm implement dealers, the chemical and fertilizer suppliers, and agriculture-related businesses—though that in itself is enough to warrant our response.

When a significant number of farmers suffer the kind of conditions we have seen in the last few years, particularly during the first part of this year, the damage is far more widespread. We are talking largely of middle-sized, or family farms—not the giant agribusiness corporations or the very small parttime farmers. According to a March report by the Department of Agriculture, 229,000 family-sized commercial farm producers are facing financial difficulty: 43,000 technically insolvent, 50,000 with extreme financial problems, and another 136,000 with serious financial problems. The total owed by these 229,000 farmers is $98.2 billion, 46.3 percent of the total farm debt. When those family farms go under, they can take an entire community with them: small businesses providing goods and services to the farmers and their families. The entire commercial and financial sectors of these small towns are at risk.

And that brings us to the subject of today's hearings: the impact of the farm crisis on the banks in these towns, the so-called agricultural banks, those with farm portfolios in excess of 25 percent. In some communities, those portfolios routinely exceed 50 percent. In addition to devoting attention to that portion of the banks' business related to agriculture, it is this committee's resposibility to be vigilant with regard to the balance of those portfolios. What kind of threat exists to the solvency of this country's community banks? Commercial banks provide fully one-fourth of all farm credit, and the threat is real and continuing. Nearly $1 billion in farm loans was charged off last year.

Last year, 32 agricultural banks failed, compared with 7 in the previous year. And 17 have failed already this year. There are over 900 banks, total, on the FDIC's problem list, more than 300 of which are agricultural banks. While most of these 300 problem agricultural banks are small by industry standards, they represent in the majority of cases, the economic heart of their communities. Regardless of the size of assets, they are vital to their towns and citizens. I believe every effort should be directed toward a means of preserving the fabric of these communities without compromising

sound business judgment, with a view toward reducing the threat to the Federal Deposit Insurance Corporation.

A number of proposals will be considered by this subcommittee, and by the full committee. I have received some proposals myself, which I would like to submit to today's witnesses for their review and comment for the record. These proposals involve a series of complex accounting procedures for making the transition through the current crisis, and I will not take the time of the subcommittee here this morning by reading them in full.

In view of the expertise represented by today's panelists, Mr. Chairman, I would very much like to have these proposals relayed to the witnesses. I appreciate the opportunity to be here this morning, and look forward to the panelists' responses.

[The material submitted by Senator Sasser follows:]

2. Farm Credit Relief Act of 1985

Recognizing the critical situation facing not only the farmers in the United States, but also the rural community banks that finance them, it is imperative that some relief be generated immediately since the farmers are presently trying to obtain crop production loans for 1985. The Farm Credit Relief Act of 1985 (the Act) could be the name of this legislation. The purpose of this memorandum is to outline several ideas, which, if implemented, would provide immediate and continuing relief to the rural community banks and to the farm customers who do business at these banks. It is believed that the ideas suggested in this memorandum would not cost the United States government any money and, additionally, would remove numerous banks from the problem list of the FDIC by making them viable, tax-paying banks. Many of the banks on the problem bank list have not paid any income taxes for years and quite a few of them have been forced to recover taxes paid in previous years because of the huge operating losses experienced over the last few years. These banks currently represent a threat to the $17 billion insurance fund of the FDIC. It is imperative that Congressional action be undertaken immediately as opposed to allowing the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of Currency (OCC) to promulgate regulations which would require a time consuming hearing process.

A. ELIGIBILITY. Only those banks deemed qualified by the Administrator of the Act shall be eligible for relief under the Act. In determining which banks would qualify (Qualified Bank), the Administrator of the Act shall use the following guidelines:

1) Total assets of the bank shall not exceed $200 million;

2) At least 25 percent of the total loan portfolio of the bank shall be agricultural loans;

3) The bank must be located in a trade area whose economy is heavily dependent upon agriculture;

4) Extension of relief under the Act to the bank must make the bank viable and able to generate a net profit;

5) There must not be any evidence of fraud or gross mismanagement on the part of the bank applying for relief.

The FDIC may object to the determination made by the Administrator of the Act as to the eligibility of a bank for relief under the Act. In the event the FDIC chooses to object, the FDIC must promptly present its evidence that such qualified bank shall not be eligible for relief under the Act. The evidence presented by the FDIC must conclusively show that the bank is not in compliance with one or more of the above guidelines used by the Administrator of the Act in determining that the bank was eligible for relief. The final decision as to whether a bank is eligible for relief under the Act shall rest with the Administrator of the Act.

Based upon the above restrictions, only rural community banks would be able to apply for relief. Regional money-center banks or international banks would not be eligible.

B. ADMINISTRATION OF THE ACT. The respective state banking commissioners, in the case of state chartered banks, and the Office of the Comptroller of Currency, in the case of national banks, would be vested with the authority of determining which banks would qualify for relief under the Act (the Administrator of the Act). State banking commissioners are more familiar with the problems facing their particular state than is the FDIC. Allowing the state banking

commissioners to administer the Act would insure that the provisions of the Act could be implemented immediately and provide the needed relief.

C. ACCOUNTING. The Act would require that those banks qualifying for relief would be required to report under regulatory accounting practices (RAP) as opposed to generally accepted accounting principles (GAAP). Qualified banks should be allowed to use push-down accounting or purchase method accounting. This method of accounting is presently available to the thrift industry.

D. REAPPRAISAL OF ASSETS. A qualified bank would be allowed to reappraise its buildings, fixed assets and equipment to fair market value and book any increase between the current book value and the fair market value into the capital accounts of the bank. At the present time many banks are selling their buildings, other fixed assets and equipment to third party purchasers who in turn lease the facility back to the bank. This method of raising capital for the bank creates a terrific expense for the bank who must pay a large enough rental payment to amortize the debt incurred by the third party purchasers to purchase the assets. This expense would be eliminated if this proposal is implemented. The net effect would mean increased capital and earnings for the bank without the related expense of the sale/lease-back method currently being employed.

E. WRITE OFF OF PROBLEM LOANS. In order to understand the restrictions contained in this section of the Act, it is necessary to specify the following definitions:

1) Fair Market Value - Fair market value shall be defined as the value of the collateral securing an eligible loan which value

shall not exceed an amount which an eligible borrower has the ability to repay from current operations based on a 30 year fully amortized loan.

2) Eligible Loans - Eligible loans shall be defined as follows:

   (a) those loans secured by farm land or farm machinery; or,
   (b) those loans made to agri-businesses; or,
   (c) such other loans as the Administrator of the Act deems eligible in order to allow the qualified bank to remain viable.

3) Eligible Borrower - Eligible borrower shall be defined as those borrowers who carry on a credit relationship with a qualified bank and who are obligated, directly or indirectly, for the repayment of an eligible loan to a qualified bank.

4) Agri-businesses shall be defined as those entities carrying on a business or trade in an agricultural community which derive at least 50 percent of their gross income from agriculture.

Qualified banks, at their discretion, would be authorized to offer the following proposal to eligible borrowers having eligible loans at qualified banks:

Renegotiated Loan

Qualified banks would be allowed to renegotiate eligible loans carried as assets of the respective qualified banks based on the following guidelines:

(a) The collateral securing the eligible loans shall be appraised by the qualified bank and the difference between the fair market value of the collateral and the book value of the eligible loan (principal and interest) would be written off over 30 years.

(b) As to that portion of the eligible loan which is equal to the fair market value of the collateral, the qualified bank shall be authorized to renegotiate the repayment of this portion of the debt on a basis which will allow the eligible borrower to repay the debt based upon the borrower's net cash flow derived from the operation of the eligible borrower. The exact repayment terms of the the renegotiated loan, including the rate of interest, terms of repayment, etc., would be renegotiated between the qualified bank and the eligible borrower, provided however, the qualified bank may require that the renegotiated loan have a balloon payment feature requiring the renegotiated loan to be paid in full within 10 years from the date of the renegotiated loan,

notwithstanding the fact that the renegotiated loan is amortized for a period of up to 30 years and that the qualified bank may choose to extend the maturity of the loan beyond the initial maturity of 10 years.

(c) In the event the eligible borrower either sells the land without the prior written consent of the qualified bank or repays the renegotiated loan prior to the maturity of the renegotiated loan, the eligible borrower shall be required to pay to the qualified bank the entire principal and interest remaining unpaid on the renegotiated loan plus that portion of the loss incurred by the qualified bank which has not been written off at the point of prepayment or resale of the collateral.

(d) Only those loans which were part of the assets of the qualified bank as of January 1, 1985, will be eligible for renegotiation under the terms of this proposal. Those loans forming a part of the assets of the qualified bank as of January 1, 1985, which are later extended or renewed without the advancement of any new loan proceeds for a period ending December 31, 1987, shall be eligible for renegotiation under this proposal, if they otherwise qualify as eligible loans.

In order to insure that funds would continue to be made available to the agricultural community serviced by the qualified bank, there could be a requirement that any qualified bank receiving relief under the Act would be required to maintain at least 50% of its total loan portfolio in agricultural loans. Failure to maintain this ratio could mean that the bank would no longer be eligible for relief under the Act and all benefits could be withdrawn immediately. The withdrawal of the benefits extended to the qualified bank shall be at the discretion of the Administrator of the Act. These requirements would encourage a bank to immediately make funds available to the agricultural community who is now experiencing a difficult time obtaining financing for crop year 1985.

Illustration of Renegotiated Loan Assume that the eligible borrower owes a $1,500,000 debt to a qualified bank bearing interest at 13% secured by 1,000 acres of land and farm equipment:

Collateral Value Prior to Renegotiation		Fair Market Value After Renegotiation	
Land	$1,400,000	Land	$450,000
Equipment	100,000	Equipment	50,000
Total	$1,500,000	Total	$500,000

Based on the above assumption, there would be a $1,000,000 loss to the bank.

Benefits to the Eligible Borrower Under present conditions the borrower owes $195,000 of interest per year to the bank or $195 per acre. If this debt is renegotiated, the renegotiated principal of $500,000 is amortized over 30 years at 12% per annum interest and the annual payment would be $62,071. This represents an annual savings of approximately $133,000 per year. At the end of 10 years the eligible borrower would owe the following to the qualified bank:

1.	1995 annual payment	$ 62,071
2.	1995 principal balance	463,642
3.	Remaining amount of $1 million loss not charged off	666,666
Total Due to Bank		$1,191,379 ($1,191/acre)

Based on the above illustration, the eligible borrower would expect a cash flow from his farming operations as follows:

Gross income per year --assumes 30 bushes of beans/acre at $6.50/bushel		$195,000
Annual expense per year --operating loan based on average cost of $125/acre	$125,000	
--annual payment	62,000	
Total Expense		$187,000
Profit		$ 8,000

Benefits to the Qualified Bank Based on the above illustration, the bank has experienced a $1 million loss in its loan. However, the qualified bank would only be required to charge off 1/30th of this amount each year, $33,333 per year. Note that the bank will receive approximately $62,000 per year in payments from the eligible borrower and most of this payment would be attributable to interest. The qualified bank now has a performing loan from an eligible borrower who has the capability of repaying the loan. Based upon the above illustration, the borrower owes $1,500 per acre or $1,500,000 to the bank. The bank would reduce the loan to $500,000 or $500 per acre. At the end of ten years the eligible borrower would have a payoff of his loan at the qualified bank in an amount less than $1,200 per acre. The inflation factor alone over the next ten years should offset the payoff of the loan at the qualified bank at the end of ten years.

F. UNGUARANTEED PORTION OF FHA AND SBA LOANS. In view of the fact that many agricultural banks have participated in the various FHA and SBA guaranteed loan programs, the unguaranteed portion of any of these guaranteed loans, that portion of the loan which is not guaranteed by the government but is retained by the bank, which have now become problem loans should be treated in the same manner as the other uncollectible or problem loans as outlined above.

G. OTHER REAL ESTATE. Qualified banks would be allowed to write off any loss it may recognize between the book value of the other real estate currently on its books and the fair market value of the other real estate over a 30-year period. Other real estate shall include not

only real property, but also any repossessed chattels carried on the books of the qualified bank.

Only other real estate which formed a part of the assets of the qualified bank as of January 1, 1985, and any additional other real estate acquired by the bank through December 31, 1987, shall be eligible for relief under this proposal.

Additionally, any expenses incurred by the bank related to the ownership of the other real estate including the payment of real estate taxes, personal property taxes, insurance premiums, payments to senior lienholders, etc., may be written off over a period of 20 years from the date the expense was incurred beginning January 1, 1985.

H. SALE OF INVESTMENT PORTFOLIO. Qualified banks should be allowed to mark all of the securities in their investment portfolio to market and sell the securities at fair market value and write-off any loss over a 30 year period. This would allow the qualified bank to eliminate any loss in its investment portfolio and to immediately use these funds to generate profits in the bank while only recognizing 1/30th of the loss on a year to year basis.

I. HOLDING COMPANY. Under this section of the Act those banks already owned by a holding company could still be certified as a qualified bank and continue to operate under existing law. Those banks not currently owned by a holding company but certified as a qualified bank under the terms of the Act should be allowed to go into a holding company if the projected net income figures using RAP accounting otherwise meet the necessary standards. Once the qualified bank has

been allowed to go into a holding company it should be allowed to continue RAP accounting.

The above suggestions represent several ideas which, if implemented, would provide a market oriented solution to many of the problems facing agriculture today. Farmers would be afforded an opportunity to produce commodities at current prices with a profit. These commodities could be competitively exported notwithstanding the current strength of the dollar. The agricultural banks would receive immediate relief and would be able to continue financing the rural communities in which they are located.

Senator DODD. Let me ask you, Mr. Madsen and Mr. Meadows—Mr. Downey, you sort of responded to this a second ago—this waiting game, I mean aside from what you seem to think about the net worth certificate, Mr. Madsen, is that really what we are talking about here?

The real answer ultimately depends upon these larger economic questions, and assuming, despite the rhetoric of some that this problem is going to reverse itself in the next year or so—I think more people realistically see this problem as something that we are going to grapple with for the next decade or more. Assuming we do the right things now, even, it is a decade or more. At least I feel that way. I don't know if you share that view at all or not.

But without doing much else, and assuming we do the right thing, assuming we back—at least reach the President's goal of a deficit reduction of $52 billion this year, $300 billion over the next 3 years—we may argue about how you get there, but let's assume for a second that we are pretty much in agreement on at least the goals.

What do you project? What do the three of you think will happen if we only did that? If we did not deal with the net worth certificate or some of these other more modest suggestions you have made, what happens to agricultural banks? What happens to the borrower? What do you see, even if we took those steps?

ONGOING NUMBER OF FAILURES

Mr. MADSEN. Mr. Chairman, I have to think that we will continue to see an ongoing number of failures in the banks. I think that that is inevitable if we don't do something to help them. While buying additional time doesn't solve the problem, time is important to agricultural banks as well as any other bank.

I think there are some things that can continue to be done by the bankers that they are doing now with their farmers in restructuring. They are spreading out the time themselves without net worth certificates. I think those kinds of things can happen.

I have to disagree with some opinions expressed earlier. Every person here this morning has been asked what effect structure and unit banking have on bank failures. Branch banks fail just as

much as unit banks. We have as an example U.S. National Bank of San Diego. Seafirst is certainly an example of a branch bank. Branching is not an answer in and of itself to this kind of a problem.

One of the people earlier suggested otherwise. If you had allowed branch banking in, say, Nebraska or Iowa, where there are a large number of unit banks, certainly they could branch, but I am not at all convinced that a larger bank is going to be willing to make loans to farmers any more than—probably not as much as—their local bank will. I don't think requiring branch banking ultimately would help the farmer in any particular way.

Senator DODD. If Senator Garn were here, he would tell you that the answer is of course to deregulate and to create a level playing field, and he may use some other words, but you know—I think you know anyway—that he has been very strong in his determination to open up the opportunities for diversification.

Now, you pointed out, and I think accurately, that a lot of the banks in the farm States deal with a—because they don't have branching, because they do deal with a single crop in many ways, because there is limited economic activity in the area they served, the opportunities for diversification are probably far less so.

EFFECTS OF INTERSTATE BANKING ON FARMERS

But assuming interstate banking, going a step further, in addition to powers, what would happen in this particular case? What would happen if interstate banking were adopted tomorrow and the Connecticut banks—the Connecticut Bank & Trust, a fairly good sized operation in my home State, decided to come on out to Iowa, or Nebraska, or Kansas, and decided to open up? What would happen to agricultural banks in that particular situation? What would happen to farmers?

Maybe Mr. Downey.

Mr. DOWNEY. If I could just try to give a brief answer to that. I am a strong believer in the community bank in this country. I think if we just looked at, for example, California, with the giants sitting out there. We open more new banks in California or in Texas than we do anywhere else.

I think the community bank has a place in this country and will continue to have it. I think people would rather deal with someone who knows their local area well, and I think the fact that some of these larger banks may be looking at these States is no indication to me that they are going to come in and be successful at them.

I still think if you talk to most of the community bankers in this country, they think they can take the larger banks head on because they give service and people look for service today, and I think they do very well.

So I don't see that as a big fear. One of the fears of expanded powers is something we will always be concerned about. If the bank management has the capacity to take on those new services, I think they should be allowed.

Senator DODD. Well, let me hear from the other two on that same subject.

Mr. MEADOWS. Well, Senator, I think the other part of the question—would an out-of-State bank be interested in acquiring a small farm bank in a Midwestern State—and I think the answer to that is probably "no."

I think even in some of these States, if the States permitted statewide branching, if a bank is not in a county seat its marketability may be rather limited. But if statewide branching were permitted, I think there might be a market somewhere in that State for a particular small bank.

We had four or five deposit payoffs in 1984 and about that same number so far this year. Generally, the reason for that is that we attempt to sell the bank to another institution and in these particular cases, in most of the cases, no one was interested in that location.

Mr. MADSEN. I think I would answer, Senator Dodd, on the basis that additional powers—customer services, if you will—for banks could have helped and may well now help some of the agricultural banks in the sense that their risk would be diversified. They would indeed have a different way of generating capital to support what are now losses in farm loans. So it could have been a help and would be in the future.

Senator DODD. What about interstate banking?

Mr. MADSEN. Well, Senator, as you know—maybe you know—Arizona has just recently passed a nationwide interstate banking bill. I do not see that bill as a panacea for the type of problems that the farmers have; however, we do see it, in our particular State at least, as a benefit for the consumers of our State.

I don't think that interstate banking, in and of itself, is going to do that much for the banks. As I alluded earlier, Arizona is a Sun Belt State. I think we have more applications for nonbank banks than any other State in the Union, so we are very popular. But in Arizona we don't have the problems that the agricultural banks face. So for us, interstate banking will help.

I think—I certainly would agree with Mr. Meadows—I think even if you had interstate banking in Iowa and Nebraska it is not going to bail out the small farm banks. It is just not going to be an answer.

Senator DODD. It was interesting, not long ago I spoke in Indiana and met for about 2 or 3 hours—this was a couple of years ago—with the presidents of a number of agricultural banks. At that time they were expressing concern. Maybe closer to Chicago this was more of an issue than, say, in an Iowa. In Connecticut, I know interstate banking is a bit more of an issue because of our proximity to New York, although we are moving in that direction with our regional compacts.

But at any rate, I remember very vividly one of these bankers expressing to me the concern of having interstate banking. He put it this way. He said, I, my father, and my grandfather, who were presidents of this local bank, have been lending money to farmers in this area not on the basis of a balance sheet. Had that been the issue 100 years ago, we never would have lent them a nickel. But I know each and every person who comes into this institution, and I know that they borrow money in March and I know they pay it back in October. And if I looked at cash flow and a lot of other

things, I would probably never approve it, and if they ended up on a computer someplace, it would never be approved.

I don't know how realistic that approach is or even how accurate it is, but I think there is a lot to be said for it, that idea of knowing the individual. Even though the numbers don't necessarily add up as you would like to see them add up, there is a lot more to go on in trusting someone who has proven over and over again they can meet obligations.

But I guess, as you point out, in these smaller States the interstate banking issue probably will just not be much of a problem.

There are a number of questions, Mr. Downey, that Senator Gorton had for you. I will submit those to you, if I may.

Mr. DOWNEY. Fine.

Senator DODD. I forget which one of you pointed out in your testimony—it may have been Mr. Beverage's testimony. Let me just ask you this. It sort of struck me when I read it.

On page 5 of his testimony: "It is impossible to say whether regulators could have or should have spotted agricultural lending problems earlier."

HINDSIGHT VIEWS

Now, I know that in the 1970's we were looking at expanding exports, we were encouraging fencepost-to-fencepost farming. But shouldn't the regulators—I mean, he struck me as saying that even though we are encouraging that—I mean, there is the problem with exports and the deficit in that particular area and high-interest rates or higher interest rates, and so forth. It is not a unique occurrence. We have been through these problems in the past.

I am curious as to why we shouldn't have seen the possibility of the kind of environment we are living in now. As I say, this wasn't the first time that it has ever happened, and I was struck by that comment.

I wonder if you might comment. Why shouldn't we have seen that? I mean, this is not something new.

Mr. MADSEN. I think, Senator, if I can try to analyze what CSBS had in mind with that comment. I think the testimony refers to the cash-flow analysis end——

Senator DODD. Yes.

Mr. MADSEN [continuing]. As opposed to the tendency, I think, in agricultural banks as well as banking in general, to look, at collateral-based lending rather than the ability to repay that loan. As you said, fencepost-to-fencepost planting meant farm land value went up and up and up and up.

Senator DODD. Right.

Mr. MADSEN. You know, the belief that the collateral is there, ergo the loan is good.

Obviously, that is not the case, and I think that probably it could have and should have been caught earlier. Both cash flow and collateral are dual edges as far as I am concerned in my role as regulator. Collateral is important, but as far as I am concerned, the ability to repay that loan is much more important than any collateral consideration because collateral is never worth as much as you think it is. Even in good times it goes down in value.

Senator DODD. And that is not unique?

Mr. MADSEN. I have made loans, so I know how that works.

Senator DODD. And that is not unique; that has happened in the past?

Mr. MADSEN. No, sir, that is not unique.

Senator DODD. Mr. Meadows.

Mr. MEADOWS. Well, it would have been very difficult, I think, for a bank examiner to attack the land values and other collateral values in the mid and late 1970's because, after all, those items were selling at prices at or in excess of what was paid for them.

I do think, though, that a number of bankers and examiners, certainly as the efforts to halt inflation took hold in 1981 and 1982, did start to recognize the problem and adopted more prudent lending standards and, as a result, are not facing the difficulty of others, who perhaps did nothing or continued to lend in expectation that inflation and increased values was going to recur.

But it would have been very difficult, I think, to predict what has happened in the mid and late 1970's.

Senator DODD. Mr. Downey, do you want to comment on that?

Mr. DOWNEY. I think the blame should be shared by all of us—borrowers, bankers, and regulators included—if there is a blame to be placed. I think the same is true in the energy area, where we probably should have asked ourselves the same question: Will oil go to $60 a barrel?

I think one of the problems we have—that I had as a bank examiner—when a bank is showing very good income from very solid sources and every time they lend out $1 they get $1.20 back and everything else, it is pretty hard at that point in time to tell them, hey, don't do any more of that good business.

So, you know, I don't mind taking the blame today for some of it as long as I can take some of the credit for the good years.

Senator DODD. A good point. We don't report about planes that fly, though, you know. [Laughter.]

We rarely have hearings on those issues.

But at any rate, I thank all three of you. I apologize that other Senators could not be here, and I am sure they may have some additional questions for you, and if they do, I presume you won't object if they send them along to you.

Mr. DOWNEY. Yes, sir.

Senator DODD. And I apologize that you had to have as a chairman a swamp Yankee from New England here, but I have learned a lot just in the few minutes being here listening to you. I happen to—I guess an awful lot of us—I should have asked you if any of you had seen "Country." And to the large part of the community, that is going to be their basis of information and, unfortunately, has a larger audience than a congressional hearing.

But I suppose, at least, to one degree they identified at least accurately some of the problems that are created, and I think people benefit from that.

At any rate, I thank you and the committee thanks you for your patience here today, your forbearance, and for your testimony, and this hearing is adjourned.

Thank you.

[Whereupon, at 11:50 a.m., the subcommittee was adjourned, subject to the call of the Chair.]

[Responses to written questions of Senator Gorton and Senator Sasser follow:]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

May 6, 1985

The Honorable Slade Gorton
United States Senate
Washington, D.C. 20510

Dear Senator Gorton:

Thank you for your interest in OCC's bank examination policies and procedures. We trust that the attached information adequately addresses each question posed in your May 1, 1985 letter.

As also requested, we have forwarded our comments to Senator Sasser on the "Farm Relief Act of 1985". A copy of our response is attached.

We appreciate the opportunity to address your concerns. The OCC shares a strong common interest with Congress, lenders, and farmers in the long-term success of the farm economy.

Sincerely,

John F. Downey

John F. Downey
Chief National Bank Examiner

ATTACHMENT

Question 1

Many of the complaints we have heard have involved your office's examination procedures at the regional offices.

(a) Do you have procedures by which unresolved issues at the regional offices can be appealed to the national office?

(b) Do you have any statistical information on the number of cases unresolved at the regional office level in which your office's intercession has been necessary? By what methods have you publicized this right of review to your constituent banks?

Response:

(a) The Comptroller has delegated to the Deputy Comptroller for each district authority to supervise all national banks with the exception of those banks classified as "Multinational" and non-delegated problem banks. Multinational banks and non-delegated problem banks are administered by the Multinational and Special Projects Divisions in Washington.

While we do not have formal appeal procedures and normally encourage resolution at the district level, it is generally well known by the national banks that a bank may request review of an examination by the district or Washington offices. In fact, the attached examining bulletin #85-4 which was used to inform examiners of the Joint Policy Statement of the Federal Regulatory Agencies on Their Agricultural Credit Policy specifically states that "the lender may seek a formal review of the matter with the local regulatory agency office."

(b) We are not aware of cases where Washington's intercession was necessary. We are in constant communication with our District Deputy Comptrollers. If a disagreement with bank management should arise, Washington would be advised and a mutually agreed-upon resolution devised.

Question 2

Has OCC promulgated more rigorous examination standards, either officially or unofficially?

(a) Is cash flow now the principal criterion for classification of loans, and does this represent a shift in your policies under which you no longer approve of asset-based lending?

(b) Does OCC require that all loans to the same borrower be classified the same?

Response

The OCC has not officially or unofficially instituted more rigorous examination standards. Loan classifications have always been based upon the identification of a well defined weakness or weaknesses that jeopardize the liquidation of the debt.

(a) Asset-based lending is suitable for certain types of lending such as accounts receivable financing. It is not now, nor has it ever been, suitable for most agricultural lending. Historically, examiners have determined an agricultural borrower's ability to repay obligations from cash flow and profitability projections. The ability to generate cash from secondary sources, e.g. proceeds from term debt and sale of assets, etc. as well as current collateral values are additional factors that may reduce the severity of weakness in a problem loan. However, in the current agricultural economic environment, the borrower's ability to generate cash through refinancing real estate has diminished due to declining real estate values. Therefore, cash flow from production is the most practical means of repayment.

(b) The OCC does not require that all loans to the same borrower be classified the same. Loans for current year production that are supported by properly controlled collateral or are expected to be repaid at the end of the operating season are not normally subject to criticism. The portion of loans secured by liquid collateral (typically livestock and grain) which is properly controlled by the bank are excluded from criticism in most instances. The portion of capital debt (typically loans to purchase capital assets and to fund past operating losses) not supported by the earning and paying capacity of the borrower and without liquid collateral support is reliant upon the liquidating values of capital assets (typically land and machinery) and is classified substandard. The portion of loans supported by collateral of questionable value is classified doubtful.

The shortfall in the collateral coverage of the loan balance is classified loss. Loans listed as Other Assets Especially Mentioned are usually characterized by negative trends where close supervision is warranted to prevent more serious repayment problems in the future.

EB 85-4

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type	Subject
Examining Bulletin	Farm Lending

To: All Examining Personnel

Attached for your information is a joint statement of the Office of the Comptroller of the Currency, the Federal Depository Insurance Corporation, the Federal Reserve System, and the Farm Credit Administration regarding the agencies' agricultural credit policy.

With this statement, the federal regulatory agencies reiterate their policy of encouraging banks and associations to handle with knowledge and understanding the credit problems of farmers and small business borrowers temporarily unable to fulfill debt service obligations.

The Office of the Comptroller supports this policy of lenders working with borrowers to solve debt problems, as well as other measures (including training programs for examiners on agricultural credit) designed to achieve a successful local farm economy.

Attachment

John F. Downey
Chief National Bank Examiner

Joint Statement of the Federal Regulatory Agencies
on Their Agricultural Credit Policy

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System (FRS) and the Farm Credit Administration (FCA) -- which regulates the farm credit system -- are reinforcing their long standing policy of encouraging banks and associations to work with farmers and small business borrowers who are experiencing temporary difficulties in meeting their debt service obligations. The regulators believe this policy is prudent provided the institutions' practices are generally consistent with safety and soundness considerations.

This statement of the agricultural credit policy of the Federal regulatory agencies is being provided to all examiners. This, along with other policy statements and regular training seminars on agricultural credit arranged for the examiners, is designed to ensure that farm credit problems will be handled with understanding.

All four regulatory agencies have recently emphasized to their examination staffs that although it is the responsibility of an examiner to point out to management the weaknesses which may be present in loans, the regulatory agencies do not require foreclosing or calling loans. Borrowers who are experiencing problems should work with their lenders, since they are the ones responsible for granting, restructuring and collecting loans. Lenders, farmers and regulators have a mutual interest in the long term success of the local farm economy.

The FRB, OCC, FDIC and FCA examiners, when analyzing a credit, consider the source of repayment, the adequacy of collateral and the ability of the borrower to repay the loan as the primary factors in assessing the quality of a loan. Generally, if a farmer is making cash payments to keep his debt service payments current and the lender and the examiner believe the farmer is able to continue to make timely debt payments, the loan will be considered a satisfactory loan, even if surrounding land values have fallen significantly, and, therefore, the farmer's financial position may not be as strong as it was when the loan was made.

As has been the long standing practice of the regulators, experienced review examiners in the regional offices will continue to analyze the examination reports submitted by examiners to ensure that they are in conformance with the above policies prior to their transmittal to the banks and associations. Before leaving each lending institution, the examiners will discuss their report findings with the management to make sure there is no misinformation regarding the institution's credit policies and procedures or loan

classifications. Should a lender have additional questions or comments about the examination report, the lender may seek a formal review of the matter with the local regulatory agency office.

Over the past several years, some farmers and farm sector borrowers have been subject to financial pressures resulting from depressed commodity prices, declining land values and the aftermath of drought. These financial pressures have resulted in increased delinquent loans in the portfolios of agricultural sector banks and associations. Some of these problems are transitory and it is reasonable to expect economic conditions in the agricultural sector to improve. Examiners will keep in mind that, under such circumstances, agricultural lenders may find that the most prudent policy is to stretch out payments rather than to take more precipitous action such as foreclosure and/or forcing a borrower into bankruptcy. Such a policy does not alter requirements on the recognition of loss loans or the accounting treatment of nonperforming or nonaccrual assets by financial institutions.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

May 8, 1985

The Honorable Jim Sasser
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510

Dear Senator Sasser:

Senator Slade Gorton, Chairman, Subcommittee on Financial Institutions and Consumer Affairs, furnished a copy of proposed legislation entitled, "Farm Credit Relief Act of 1985" to the Comptroller of the Currency. Our agency's evaluation of its provisions and effects is furnished in accordance with your request.

I assure you that, as regulators of national banks, we are concerned about the plight of the nation's farmers. We recognize that the problems currently faced by many commercial banks are inextricably tied to the problems of the agricultural industry.

However, our agency does not believe that the proposed legislation offers an appropriate solution to the agricultural bank problem. In our opinion it suffers from the following deficiencies:

- It would seriously distort the financial statements of affected banks, undermining public confidence;
- It would have adverse public policy implications; and
- It assumes that its interventionist measures are necessary, ignoring the underlying strength of the agricultural bank industry.

This response discusses each of these deficiencies as well as other specific concerns.

Distortion of Financial Statements

Accounting policies similar to those proposed by this Act were adopted in desperation a couple of years ago by the financially distressed thrift industry. We believe that the experience of the thrift industry makes a strong case for resisting similar solutions in the future. This is best exemplified by the fact that such policies have not altered the fundamental weakness of the thrift industry--they have only covered them up, albeit ineffectively. The disguise of these problems has not gone unnoticed by the public and as a result, the credibility of financial reporting by thrifts has diminished.

The accounting policies advocated by this Act can be criticized on the same grounds -- they lack substance. They provide for the selective write-up of assets such as property and equipment which have increased in value, and the deferral of losses on assets such as loans, investments, and other real estate which have decreased in value. While not providing any real earnings, capital or liquidity, these policies would merely employ accounting legerdemain to distort the financial statements of banks to which they were applied.

And as with the thrifts, the obvious result of this distortion would be a decline in financial reporting credibility suffered by the banking industry. This eventuality is particularly disturbing to our agency because we believe that market discipline within the banking industry is fostered by credible public disclosure of relevant financial information.

Adverse Public Policy Implications

If enacted this legislation would also have public policy implications that are undesirable.

First, it would establish a bail-out precedent encouraging greater risk-taking by agriculture and other banks.

Second, providing relief to agricultural banks would constitute an obvious inequity since similar assistance was not available to failed banks in other troubled industries such as energy, timber, and real estate development.

And third, this Act would undermine the OCC's efforts to promote safety and soundness within the banking industry. Our efforts are predicated upon an ability to maintain market discipline by holding banks accountable for their own decisions. By granting relief from conventional accounting requirements, and as a result from the risk of failure, such discipline is destroyed.

Underlying Industry Strength Is Ignored

The proposed Act assumes that its interventionist measures are necessary to protect the Federal Deposit Insurance Fund. Our agency believes that such an assumption is unwarranted.

While presently beset with difficulties, over the years agricultural banks have enjoyed a very favorable return on assets when compared to non-agricultural banks. Accordingly, the average agricultural bank has been more highly capitalized than a non-agricultural bank. Today, the ratio of primary capital to total assets is more than 10 percent for agricultural banks compared to 9 percent for non-agricultural banks. Indeed, despite recent problems, dividends paid by Midwestern agricultural banks almost doubled between 1979 and 1984, from $122 million to $238 million.

Considering these factors the OCC does not believe that the current difficulties warrant extreme remedies. On the contrary, we believe the majority of agricultural banks will survive, recover and prosper.

Other Specific Comments

In addition to the conceptual concerns expressed in the preceeding section, the following comments are provided on specific items in the proposed legislation.

RAP vs. GAAP

The Act would require "banks qualifying for relief . . . to report under regulatory accounting practices (RAP) as opposed to generally accepted accounting principles (GAAP)."

Unlike GAAP, the term RAP does not embody any specific set of accounting practices. Rather, RAP generally refers to anything promulgated by regulators which is not GAAP. Therefore, it is

not precisely clear as to which regulatory practices are being advocated by this legislation. For the purposes of this response we have assumed that RAP refers only to the specific deviations from GAAP which are discussed in the Act.

Purchase Method and Push-Down Accounting

While related, purchase method and push-down accounting are not synonymous. The purchase method of accounting is one of two methods (as contrasted with the pooling of interests method) prescribed by Accounting Principles Board Opinion No. 16 to account for a business combination on the books of the combined entity. Under this method, the assets and liabilities of the acquired business are recorded at fair market value.

Push-down accounting is a separate concept which embraces the notion that adjustments resulting from the application of the purchase method should also be "pushed down" to the books of the acquired business if it remains a separate entity after the combination.

In any event, the availability of push-down accounting to banks is not relevant to this legislation because its only appropriate use would be in connection with a business combination.

Renegotiated Loans

The proposed legislation encourages banks to accept limitations on their ability to renegotiate loans by allowing them to amortize collateral deficiencies over 30 years. Apart from our fundamental aversion to loss deferrals, we are opposed to this aspect of the legislation because it would induce banks to make decisions based upon accounting implications rather than real economic considerations. For example, by accepting the 30 year amortization option, a bank would have to forego the opportunity to renegotiate full repayment of a loan. In the event that such a loan would otherwise be fully collectible, this would represent a true economic loss to the bank. Adversely impacting the position of the bank's shareholders and uninsured depositors, this situation would constitute an unsafe and unsound banking practice.

In summary, we believe that this proposed legislation is an inappropriate solution to the farm debt problem. If enacted, it would jeopardize the financial reporting credibility of the

banking industry and promote bad public policy. Further, it is our belief that its radical measures are not warranted by the condition of the ag bank industry.

Sincerely,

John F. Downey

John F. Downey
Chief National Bank Examiner

cc: The Honorable Slade Gorton
Chairman
Subcommittee on Financial
Institutions & Consumer
Affairs

○